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Viewpoint

Deferred Compensation

Executive Employment Agreements Must Comply With Section 409A

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EXECUTIVE COMPENSATION

Section 409A of the Internal Revenue Code imposes strict new requirements on nonqualified deferred compensation. Notice 2005-1 turns many executive employment agreements into "deferred compensation" subject to Section 409A. This article outlines what taxpayers should know about Notice 2005-1 and its effect on executive employment agreements.

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Beginning this year, all of your executive employment agreements are at risk for the stiff tax penalties on "deferred compensation" under new Section 409A of the Internal Revenue Code.

In this article, we show you how to apply Treasury's new guidance under Notice 2005-1 to (1) identify "deferred compensation" in your employment agreements, and (2) ensure it complies with tax code Section 409A.

The first thing you should know is that the range of employment agreements made subject to Section 409A is much broader than you may think.

In a nutshell, Notice 2005-1 tells you to identify every payment promise that is capable of being paid out more than 2 1/2 months after the year it vests. Notice 2005-1 says these are deferred compensation under Section 409A, and must be crafted accordingly. These will include typical multiyear salary agreements, reimbursement agreements (e.g., for club dues, relocation expenses, and financial planning fees), and indemnification agreements. They are unlikely to be grandfathered, even if contained in pre-2005 agreements, so operational compliance may be required immediately, and document compliance by the end of 2005.

Later guidance may temper these rules. In the meantime, prepare to fit your employment agreements under them--or prepare to ask Treasury for rules you can live with.

Background: Section 409A's Surprising Sweep

The statute. New Section 409A governs permitted payouts and elections of "deferred compensation." Failure subjects vested deferred compensation under the "plan" to taxation plus interest on the tax since the vesting date, plus additional tax equal to 20 percent of the compensation.

Broad rule, narrow grandfather. Notice 2005-1 magnifies the risk for employment agreements in three key respects: First, it defines "deferred compensation" to sweep most typical employment agreements under Section 409A. Second, it invents a startling aggregation rule which defines the failed "plan" as every arrangement of the same type covering the same employee. Plan types are defined broadly as account balance (defined contribution), non-account balance (defined benefit) and other (typically, equity-based) plans. Third, it narrows the grandfather rule so that most typical promises in existing executive compensation agreements are not grandfathered, even if vested by Dec. 31, 2004.

Example. Consider a typical promise to reimburse the executive for financial planning expenses up to $5,000 per year, generally payable when requested by the executive. The promise is "deferred compensation" subject to Section 409A. As drafted, it fails Section 409A, so the $5,000 promise is subject to taxation plus a 20 percent additional tax when it vests. The failure is also imputed to every benefit in the same "plan"--under the new aggregation rule, every defined benefit-type promise of deferred compensation payable to that same executive. These may include all the executive's reimbursement agreements, indemnification agreements, and nongrandfathered accruals under the defined benefit supplemental executive retirement plan (SERP). In our fairly typical example, failure of a $5,000 perk triggers taxation and penalties for a multi-hundred thousand dollar SERP benefit, as well as other benefits.

Action Items for Your Employment Agreements

(1) Know How to Spot Deferred Compensation: The 2 1/2 Month Rule. Deferred compensation is any compensation that is payable in a year after the year the employee has a "legally binding right" to it. On the basis of conversations with Treasury staff, a legally binding right appears to mean an enforceable agreement, including any agreement that becomes enforceable only after a specified contingency arises. The amount is not deferred compensation, however, if it is scheduled by the terms of the agreement to be paid no later than 2 1/2 months after the taxable year in which it is no longer subject to a "substantial risk of forfeiture," which we here shorthand as "vesting."

How do you apply this rule in practice?

(a) *Identify the vesting condition*. This is the last act or event that entitles the executive to receive the compensation. Some promises-to-pay are made unconditionally, with no later vesting condition. These promises are considered to vest when the "legally binding right" is created.

(b) *Apply the 2 1/2 month rule*. If compensation under the agreement is not expressly scheduled to be paid within 2 1/2 months after the taxable year in which it vests, it is deferred compensation under Section 409A. One break is given here: the "taxable year" of vesting is the later of the employer's taxable year, or the employee's taxable year--useful for employers with noncalendar fiscal years.

(c) *Some vesting conditions are ignored*. Notice 2005-1 says that you must ignore vesting conditions that do not pose a "substantial risk of forfeiture" under tax code Section 83--generally, conditions where the employee's risk of not being paid is small

should he or she terminate employment (e.g., pay guaranteed unless fired "for cause"). Also, ignore any requirement that services not be performed (e.g., a noncompete agreement). Finally, ignore conditions not "related to the purpose of the compensation." The category of conditions "related to the purpose of the compensation" is narrowly defined as those conditions related either to the employee's "performance" for the employer, or to the employer's "business activities or organizational goals." Treat promises with ignored vesting conditions like unconditional promises to pay: Apply the 2 1/2 month rule to the taxable year the legally binding agreement is made.

(d) *Recognize that the vesting concept is key but undefined.* The 2 1/2 month rule hinges the entire definition of deferred compensation under Section 409A on when compensation vests--but leaves this key concept largely undefined.

(2) Identify Specific Deferred Compensation Promises. Unless the agreement expressly states that amounts must be paid within 2 1/2 months after the year of vesting, they are likely to be Section 409A deferred compensation. Remember: once promised pay is deferred compensation under Section 409A, it must meet the all the rules of Section 409A. For example, the agreement must specify in writing that payouts may occur only on a fixed date, fixed schedule, or permitted event; payouts keyed to separation from service must meet the six-month-delay rule for key employees of a publicly traded corporation, and so forth.

Look for the following promises:

(a) *Pay guaranteed unless fired "for cause" or quits without "good reason."* Employment agreements typically guarantee pay over a period of years unless the executive is fired "for cause" or quits without "good reason." Treasury officials apparently believe that a "quits without good reason" forfeiture clause does not raise a substantial risk of forfeiture in all cases. The thinking is not entirely clear, but Treasury staff may be worried about line-drawing between "good reason" conditions that are substantial and those that are not, or about the possibility of manipulation. 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.

If the agreement vests in the taxable year when made, virtually all amounts will be payable after the 2 1/2 month window, will be subject to Section 409A at the outset, and must be drafted to comply with the fixed-date payout rule, the six-month-delay rule, and so forth. By contrast, if you judge that your specific "quits without good reason" forfeiture is so effective that it forestalls earlier vesting, then the amounts vest only as the services are rendered. Drafting in this case is easier; you can avoid Section 409A altogether by requiring that amounts be payable within 2 1/2 months after the taxable year in which services are rendered and the promised amounts vest.

Notice 2005-1 applies a good-faith compliance standard. For now, this probably allows you to determine whether a good-reason-to-quit clause is a good vesting condition--or not, in which case the agreement vests in the taxable year when made. After 2005, to err on the side of caution you would assume that all such promises vest in the taxable year when made. Most amounts would be payable later than 2 1/2 months after the taxable year of vesting, would thus be subject to Section 409A at the outset, and would be drafted to fit the fixed-date payout rule, and the like. To err on the other side is to risk subjecting all payments under the agreement to penalties under Section 409A.

(b) *Pay conditioned on signing a future release.* Many employment agreements 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. Is the executive's contingent right to these future severance amounts (a right that will not exist until the executive accepts the

employer's offer by signing the release) subject to Section 409A, and if so, when?

We think the better answer under Notice 2005-1 is that the employment agreement creates the "legally binding right" (albeit a contingent one), and the release contingency must be analyzed as a possible vesting condition. If the release requirement is an ignored vesting condition under Section 409A, then the agreement is considered to vest when the agreement is made.

(c) *Performance pay.* For performance-based pay, the vesting event is generally the satisfaction of the performance condition. Why? 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 1/2 months of the taxable year the performance condition is met. If the 2 1/2 month rule is not met, however, the amounts will generally be deferred compensation subject to Section 409A.

(d) *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 tax code Section 132(a). These are not subject Section 409A. Others are taxable, such as reimbursement of tax return preparation and financial planning fees. If payable more than 2 1/2 months after the vesting year, these are deferred compensation under Section 409A.

It is unclear when these amounts vest. One possibility is that they vest upon the occurrence of the reimbursable event, for example, the actual preparation of the tax return. This is the last event that entitles the employee to the money, and it is arguably "related to the purpose of the compensation." But Treasury staff has unofficially stated that the vesting event is not the occurrence of the reimbursable event. They apparently believe that the occurrence of the reimbursable event is not "related to the purpose of the transfer" under the narrow definition of Notice 2005-1. Under Treasury staff's apparent position, 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.

(e) *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). But others 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 parachute payments payable solely upon a change in control, and relocation make-whole agreements (e.g., for any loss on sale of a residence). These amounts are deferred compensation subject to Section 409A if payable more than 2 1/2 months after the vesting year.

As with reimbursements, what constitutes the vesting event for a contingent payment is unclear. It may be when the contingency arises. But given Treasury's apparent skepticism that the occurrence of the contingency is a "condition related to the purpose of the compensation," the vesting event may well be earlier, i.e., when the employee performs the services that entitle him or her to qualify for the coverage, or when the agreement is made.

(f) *Involuntary terminations?* For amounts that are payable solely upon an involuntary termination of employment, Treasury staff is apparently considering making the involuntary termination the vesting event under Section 409A. Under this approach, involuntary termination severance pay would not vest until the termination date. If required by the agreement to be paid within 2 1/2 months after the year of termination,

it would not be deferred compensation under Section 409A. Do not count on this rule being finalized any time soon, however. There are indications that Treasury staff may be concerned about the difficulty of sorting out involuntary terminations from other kinds.

(3) Check Your Current Agreements to See if Grandfather Applies--It May Not. Section 409A generally provides that amounts earned and vested as of Dec. 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 signed by Dec. 31, 2004.

First, the grandfather covers only amounts that were vested as of Dec. 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 Dec. 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 Dec. 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 Dec. 31, 2004, they are not grandfathered. Here's why: When valuing the compensation subject to the grandfather protection, Notice 2005-1 tells you to take the present value, as of Dec. 31, 2004, of the amount guaranteed under the plan if the participant "voluntarily terminated services without cause" on Dec. 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 Dec. 31, 2004, would be nonpayable if he or she quit without good reason, then the compensation is not covered by the grandfather.

Bottom line: If your salary promise has a "quits without good reason" exception, it is clearly not covered by the grandfather (although it may be unclear whether it is vested).

(4) Draft New Promises to Fall Outside of Section 409A, to the Extent Possible. You can 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 1/2 months after the year in which they vest. But this drafting strategy may not work for reimbursement agreements and contingent payment agreements, among others.

(5) Unclear Definition of Vesting Makes Drafting Strategy Imperfect. We have noted that vesting for Section 409A purposes is ill-defined. For example, consider reimbursements of financial planning expenses. Do amounts vest when the financial planning services are provided? Or, as under Treasury's apparent current thinking, does vesting occur when the employee performs the services entitling him or her to the financial planning reimbursement perk? Given this uncertainty, the 2 1/2 month rule may very difficult to draft.

For example, consider an agreement that promises to reimburse the executive's financial planning fees for five years after termination of employment. Under Treasury's apparent current thinking, this promise vests, at the very latest, at termination of employment. Viewed this way, every reimbursement is payable more than 2 1/2 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.

(6) Make Sure That Section 409A-Covered Promises Meet Section 409A's Payout and Reporting Rules. Many agreements are designed up-front to pay out more than 2 1/2 months after vesting. We have noted the common example of multiyear employment

agreements promising a stated salary unless the executive is fired "for cause" or quits without "good reason." Depending on how tightly the "for cause" and "good reason" conditions are drafted, many such promises are vested immediately for Section 409A purposes when the agreement is signed. Under the written terms of the agreement, any salary payable more than 2 1/2 months after the year the agreement is signed must pay out only on fixed dates, according to a fixed schedule, or on permitted payout events.

Treasury staff has said informally that the fixed-date-or-schedule requirement is met if the agreement merely specifies the taxable year of payment. It is not yet clear whether an agreement containing a commonly used phrase like "according to the employer's normal payroll practice" meets the fixed-payout-schedule requirement. Deferred compensation under Section 409A must be reported on new box Y of the employee's W-2 (see (13) below).

(7) Remember the Six-Month Rule for Springing Severance Pay. Typically, guaranteed pay will change in timing or amount after termination of employment. For example, a multiyear 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.

(8) Watch Out for Modifications and Renegotiations of Agreements. If payments promised under an agreement are deferred compensation subject to Section 409A, then any acceleration of the promised payments is 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 five-year rule and other applicable rules.

(9) Understand the Impact of the Plan Aggregation Rule. As we have noted, Notice 2005-1 applies a startling aggregation rule. For penalty purposes, the "plan" is any plan of the same type covering the same individual. Three plan types are identified for this purpose: account balance (defined-contribution type) plans, non-account balance (defined-benefit type) plans, and other, typically equity-based plans. Any failure of any plan triggers penalties on all plans of the same type covering the same individual.

This means any failure in your executive compensation agreement could be especially catastrophic when applied to SERP benefits. Return to our example of the employer's promise to reimburse financial planning fees up to $5,000. This is a nonaccount balance (defined-benefit type) deferred compensation plan. If it fails Section 409A, all nongrandfathered accruals under the executive's defined benefit SERP will be subject to tax plus interest from the date of vesting, plus an additional 20 percent tax. For long-standing nongrandfathered SERP accruals, interest alone could multiply the tax consequences of Section 409A failure.

(10) Consider Indemnifying Participants. Companies may want to provide--or participants may insist on--indemnification for tax penalties caused by company mistakes. Remember that any tax indemnification promise can itself be subject to Section 409A. If your existing agreements are grandfathered (see (3) above for common instances where they are not), adding an indemnification provision will not itself blow the grandfather--but the indemnification promise is, of course, not grandfathered.

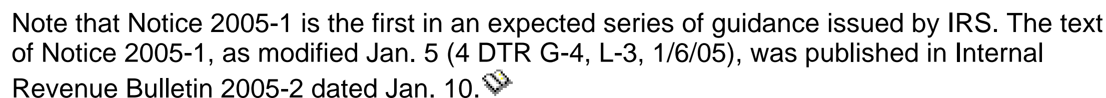
(11) Watch for Changes in the Terms of Outstanding Options and SARs. Very generally, options and stock appreciation rights (SARs) granted "at the money" are excluded from the definition of deferred compensation subject to Section 409A. But watch for one catch. It is not unusual for the terms of an outstanding option grant to be modified in some circumstances. For example, if the participant terminates employment, the option exercise period may be extended. If the extension 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.

(12) Check Your 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 event for accelerating payment of compensation. These rules have some surprising twists. For example, they apparently prohibit such accelerations in certain instances when there are multiple corporate guarantors of the promise. Check your change-of-control acceleration clauses. If they provide accelerated payout, and not merely accelerated vesting, make sure that they meet the highly technical requirements of Notice 2005-1.

(13) Prepare to Implement Your W-2 Reporting. All compensation subject to Section 409A must be reported on new Box Y on the employee's W-2. It is hoped that Treasury guidance will clarify this requirement. Consider the example of a five-year employment agreement, with two years of salary payments guaranteed if the executive is fired without cause. Since we have reason to believe that at least these two years of promised salary are vested when the agreement is made, we can conclude that least some amounts under the agreement are immediately subject to Section 409A. But how the Section 409A-covered amounts in our example would be valued and reported is still unclear.

Note that Notice 2005-1 is the first in an expected series of guidance issued by IRS. The text of Notice 2005-1, as modified Jan. 5 (4 DTR G-4, L-3, 1/6/05), was published in Internal Revenue Bulletin 2005-2 dated Jan. 10.



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