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Executive Compensation

In addition to focusing on rules governing performance-based compensation under Section 409A of the tax code, this article also takes into account a recent Internal Revenue Service private letter ruling that may undermine the validity of performance-based compensation arrangements subject to Section 162(m) that are commonly found at many public companies. The authors also review Section 409A transition relief available during 2008 that allows employees to make deferral elections on a more liberal basis.

Six-Month Deferral Elections and Performance-Based Pay Under Section 409A

BY ERIC COTTS AND JOHN MCGUINESS

This article discusses the deferral election rules for ''performance-based compensation'' under Section 409A of the Internal Revenue Code (Section 409A). Specifically, it outlines the requirements for amounts to be treated as performance-based compensation under Section 409A and for use of the special six-month rule for an election to defer such compensation.

The final regulations under Section 409A (the Final Regulations)[1] provide that an election to defer compensation generally must be made in the year before the compensation is earned (i.e., by December 31 of Year 1 in order to defer amounts earned during Year 2). As with many general rules, however, there are a number of exceptions. The particular exception discussed in this article—for elections to defer performance-based compensation—is one on which many companies rely. This is because compensation paid under the following common incentive compensation arrangements may qualify as performance-based:

- an annual cash bonus plan,
- a long-term cash bonus plan (e.g., one with a three-year performance period),

[1] The Final Regulations (72 Fed. Reg. 19,234 (Apr. 17, 2007)) generally become effective on Jan. 1, 2009. Until that time, taxpayers generally must administer their plans in accordance with existing guidance (i.e., chiefly, IRS Notice 2005-1, 2005-1 C.B. 274), or, where an issue is not addressed in existing guidance, using a reasonable, good faith interpretation of Section 409A (which might include rules set forth in the Final Regulations). See IRS Notice 2007-86, § 3.01(A), 2007-46 I.R.B. 990.

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 ISSN 1069-5117

- a performance share or unit plan, and
- a performance-based restricted stock unit (RSU) plan.

Background. Performance-based compensation is commonly thought of as compensation that is earned based on how a company or individual (or both) perform when measured against predetermined performance standards. For example, payment of an annual bonus might be based on an employee's rating for the year on a scale from 1 to 5, or based on a company's revenues for the year. Performance is usually measured over a given period of time referred to as the ''performance period.'' The performance period might be one year, as is common in annual corporate bonus plans, or three years, as is common in long-term incentive plans. Either way, employees granted such awards generally do not know how actual performance measures up against the relevant performance standards—and thus how much of a bonus is likely—until a portion of the performance period has transpired.

Fortunately, the Final Regulations allow an employee to make a deferral election with respect to ''performance-based compensation'' at any time up until six months before the end of the performance period (e.g., on or before June 30th for calendar year incentive plans).[2] However, it is not always easy to determine whether an amount qualifies as performance-based compensation under the Final Regulations. Making matters worse, a recent private letter ruling issued by the IRS in an analogous area, performance-based compensation under section 162(m) of the Internal Revenue Code (Section 162(m)), has created additional uncertainty on this issue.

As a result of this uncertainty, some companies may be allowing ''six-month deferral elections'' on incentive compensation that does not qualify as performance-based compensation for purposes of Section 409A. An impermissible six-month deferral election could result in an inadvertent and costly violation of Section 409A.[3] Therefore, it is important for employers to understand what constitutes performance-based compensation eligible for a six-month deferral election under Section 409A.

Performance-Based Compensation Under Section 409A. The requirements that must be satisfied for compensation to qualify as performance-based under the Final Regulations are described below. Before reviewing these requirements, it is useful to have an understanding of how these requirements compare to similar requirements for performance-based compensation under Section 162(m).

Section 162(m) limits to $1 million the annual compensation per covered executive that a public company may deduct. However, performance-based compensation does not count toward this $1 million limit. The legislative history of Section 409A and the preamble to the proposed regulations under Section 409A (''Proposed Regulations'') indicate that performance-based compensation under Section 409A should be required to meet certain requirements similar to those for performance-based compensation under Section 162(m), but not all of the requirements under that section.[4] However, neither the legislative history nor the Proposed Regulations describe exactly which Section 162(m) requirements need to be met and which ones do not. As discussed below, the requirements for performance-based compensation under the Final Regulations are significantly easier to meet than those under Section 162(m).

Pre-established Performance Criteria. Performance-based compensation under Section 409A must be contingent on the satisfaction of preestablished company or individual performance criteria relating to a performance period that lasts for at least 12 consecutive months.[5] Performance criteria are considered to be preestablished if they are committed to writing no later than 90 days after the performance period starts. Unlike performance criteria under Section 162(m), the performance criteria may be subjective,[6] and performance-based compensation may include payments based on performance criteria that are not approved by a company's compensation committee or stockholders.[7]

Thus, bonuses payable based on subjective criteria, like an employee's performance rating, may qualify as performance-based compensation. Whether the criteria are objective or subjective, they must be put in writing in the first 90 days of a performance period.

Payment Regardless of Performance or Where Level of Performance Is Substantially Certain To Be Met When Criteria Established. Performance-based compensation does not include any amount, or separately designated portion of any amount, that will be paid regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria is established.[8] Thus, any guaranteed portion of a bonus amount will not qualify as performance-based compensation. Similarly, if the same company or individual performance criteria are used for a bonus each year, and the criteria have always been met, it may be difficult to argue that the outcome is substantially uncertain at the time the criteria are established and that the bonus is performance-based.

Payment Upon Death, Disability or Change in Control Event. Compensation will still be considered performance-based even if the plan (or another document) provides for automatic vesting and eventual payment of the compensation due to certain events. Specifically, vesting upon an employee's death or upon the employee's disability (as defined in the Final Regulations)[9] or a change in control event (as defined in the

[2] Treas. Reg. § 1.409A-2(a)(8).

[3] This type of violation would generally result in the relevant executive immediately paying tax on his vested deferred compensation plan account balance that is subject to Section 409A, plus a 20 percent additional tax and interest on this amount.

[4] H.R. Conf. Rep. No. 108-755, at 732 (2004); Proposed Regulations, Preamble § V.C., 70 Fed. Reg. 57930, 57943 (Oct. 4, 2005).

[5] Treas. Reg. § 1.409A-1(e)(1).

[6] Treas. Reg. § 1.409A-1(e)(2). Any subjective criteria must be bona fide and relate to the performance of the employee, a group of employees that includes the employee, or a business unit to which the employee provides services; and the determination that any subjective criteria have been met cannot be made by the employee or the employee's family member, or a person who is, or whose compensation is, under the effective control of the employee or family member.

[7] Treas. Reg. § 1.409A-1(e)(1).

[8] *Id.*

[9] The Final Regulations contain a special definition of ''disability'' for this purpose. Treas. Reg. § 1.409A-1(e)(1).

  BPR ISSN 1069-5117

Final Regulations) will not jeopardize the performance-based status of compensation. A similar rule exists for performance-based compensation under Section 162(m).[10] The IRS presumably allows these vesting triggers because they are generally outside of the control of the employer and the employee. Of course, it is important to remember that if vesting occurs for an employee due to one of these events rather than achievement of the performance criteria, the resulting payment to the employee will not be treated as performance-based compensation.

Payment Upon Termination Without Cause or for Good Reason. Incentive compensation plans (or a separate document, such as an employment or change in control agreement) often provide that amounts payable upon the satisfaction of performance criteria will vest upon the occurrence of an involuntary termination without cause or a ''good reason'' resignation. The Final Regulations do not address whether such vesting rules will jeopardize the performance-based status of an incentive compensation amount. Similarly, the Section 162(m) regulations do not address this issue. However, in two private rulings, the IRS held that such vesting events would not cause a problem under Section 162(m).[11] In one of the rulings, the IRS said these events were both involuntary terminations and similar to the permissible vesting events under the Section 162(m) regulations—death, disability and change in control.[12]

Based on the Section 162(m) rulings, many public companies allow accelerated vesting of incentive compensation upon a termination without cause or a resignation for good reason. In evaluating these incentive plans under Section 409A, many companies have also assumed that the existence of these accelerated vesting provisions would not alter the performance-based status of the compensation under Section 409A.

Recently, however, the IRS issued a surprising private ruling under Section 162(m) that contradicts its prior holdings on this issue. Specifically, the IRS held that the mere existence of a provision accelerating vesting upon a termination without cause or upon a good reason resignation destroys the performance-based nature of the compensation for purposes of Section 162(m).[13] More recent informal comments from IRS officials indicate that further guidance may be forthcoming on this issue. However, public companies may ultimately need to consider removing these types of provisions from their incentive plans or related documents.

If the analysis from this recent Section 162(m) ruling is carried over to the performance-based compensation analysis under Section 409A, there could be an additional reason for companies to consider removing such provisions. As mentioned above, the regulations under both sections contain similar rules on this particular point (i.e., vesting on death, disability, and change in control is permissible). However, the requirements for performance-based compensation under Section 409A are significantly less demanding than those under Section 162(m), as per the legislative history of Section 409A. Thus, it is not clear that the analysis in the recent Section 162(m) ruling would apply in the less demanding Section 409A context.

Special Rule for Equity Compensation. An award will qualify as performance-based compensation under Section 409A if its value is based *solely* on an increase in the value of the employer, or a share of stock in the employer, after the date of a grant. However, if the value of an award is equal to the value of a number of shares of employer stock, it will not be considered performance-based compensation unless otherwise subject to a performance-based vesting condition. This generally means that compensation earned from stock options and stock appreciation rights (SARs) will be performance-based, and compensation earned from restricted stock and restricted stock units (RSUs) will not.

Practically speaking, however, the special performance-based rule for equity compensation is of little utility. Stock options and SARs are generally exempt from Section 409A as long as they meet certain requirements, one of which is that the stock option or SAR must not contain an additional deferral feature. So allowing a deferral election would subject a stock option or SAR to the requirements of Section 409A. Since stock options and SARs do not normally comply with Section 409A's fixed payment provisions, it is unlikely that treating stock options or SARs as performance-based compensation will be of interest for many companies.

Rules for the Six-Month Deferral Election. The Final Regulations provide that an election may be made to defer performance-based compensation up to the date that is six months before the end of the performance period, provided:

(1) the employee performs services continuously from the later of the beginning of the performance period or the date the performance criteria are established through the date the election is made, and

(2) in no event may an election to defer performance-based compensation be made after such compensation has become ''readily ascertainable.''

This first requirement above needs to be kept in mind for new hires and terminating employees. The second requirement is explained below.

Readily Ascertainable. If compensation is a specific amount or an amount that can be calculated, the compensation is ''readily ascertainable'' if and when the amount is first substantially certain to be paid. For example, if an employee has a right to $10,000 if a certain revenue level is attained, it is too late to make a deferral election once the required revenue level is reached.

If, on the other hand, the compensation is not a specific amount or cannot be calculated because, for example, the amount may vary based upon the level of performance, the compensation is readily ascertainable when the amount is first both able to be calculated and is substantially certain to be paid. For this purpose, compensation may be allocated between the portion that is readily ascertainable and the amount that is not readily ascertainable. Generally speaking, any minimum amount that is both able to be calculated and is substantially certain to be paid will be treated as readily ascertainable.

For example, assume a company agrees to pay an employee a cash bonus at the end of a year equal to a percentage of the company's revenues for the year in excess of $500 million. By June 30th of the relevant

[10] Treas. Reg. § 1.162-27(e)(2)(v).
[11] PLR 199949014 (Sept. 9, 1999) and PLR 200613012 (Dec. 5, 2005).
[12] PLR 199949014 (Sept. 9, 1999).
[13] PLR 200804004 (Sept. 21, 2007).

year, the company already has $600 million in revenue and no election to defer has been made. As of that date, the performance-based compensation with respect to which an election to defer can be made does not include the portion of the bonus attributable to the revenues of $100 million in excess of $500 million, because the amount may be calculated and the performance requirement has been met. However, the bonus is bifurcated so that a six-month deferral election may be made on any additional bonus amount that as of June 30th is not substantially certain to be paid.

Another situation where the readily ascertainable rule may become an issue is when an employee has an incentive amount payable based on performance over a three-year period. While a deferral election could be made up until June 30 of the third year of the period, if the amount can be calculated and the performance criteria is substantially certain to be met at that time, it may be too late for an election.[14]

Transition Rules Will Help in 2008. For companies caught off-guard by the uncertainty in this area, there is some good news. The IRS has extended the effective date of the Final Regulations until Jan. 1, 2009. In addition, the IRS has stated that deferral elections can be made as to amounts that would otherwise be exempt from Section 409A as short-term deferral amounts, as long as those elections are made before Dec. 31, 2008, and before the year in which the amount otherwise would have been paid.[15] Short-term deferral amounts are amounts designed to be paid to an employee no later than two and a half months after the year in which the substantial risk of forfeiting the amounts lapses (e.g., March 15th for calendar year bonus plans). Moreover, there is broad transition relief extending to the end of 2008 that allows employees to modify their elections as to the timing and/or form for payment of deferred compensation that is subject to Section 409A.[16]

Thus, a company should be able to permit a deferral election to be made all the way up to and including Dec. 31, 2008, with respect to an annual bonus or other incentive compensation amount that is otherwise intended to be performance-based compensation under Section 409A and not otherwise payable in 2008.[17] Of course, on and after Jan. 1, 2009, companies will need to ensure that six-month deferral elections are permitted only on amounts that are performance-based compensation, and which have been timely deferred in accordance with the election procedures under Section 409A.

Conclusion. Because of the complexity of these rules, companies should review the deferral election procedures for bonuses and other incentive compensation under their nonqualified deferred compensation plans as soon as possible. Companies that are permitting or plan to permit six-month deferral elections as to such amounts may need to make changes to their incentive compensation and/or deferred compensation plans in short order. Public companies should also consider the recent IRS ruling under Section 162(m) as they review their incentive compensation plans.

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[14] Regulations under Section 162(m) may provide analogous authority on when performance goals are substantially certain to be met. Treas. Reg. § 1.162-27(e)(2)(vii).

[15] IRS Notice 2007-86, § 3.01(B).02, 2007-46 I.R.B. 990, 991.

[16] *Id.*

[17] Although such ''late'' elections are permissible under Section 409A, IRS transition relief specifically provides that other rules (e.g., constructive receipt) affecting the timing of deferral elections still apply. *Id.*; Proposed Regulations, Preamble § XI.C., 70 Fed. Reg. 57,930, 57,954 (Oct. 4, 2005).

  BPR ISSN 1069-5117