Common 409A Problems After the Transition Period

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Code Section 409A, passed by American Jobs Creation Act of 2004, consisted of only about 2,700 words. The 409A regulations, finalized in April, 2007, were approximately 110,000 words long. And now that the reasonable, good-faith transition period is over beginning January 1, 2009, every one of those words is fully in effect. Given the onerous penalties involved in any 409A compliance failure, most employers are working hard to avoid errors. However, some of the more complex rules of the 409A regulations are continuing to create plan design and drafting issues for employers. This article will discuss a selected few of those issues so that employers can be aware of them to avoid them in the future and take necessary corrective steps with existing plans.

WHEN IS A SEPARATION FROM SERVICE A "SEPARATION FROM SERVICE" FOR MAKING DISTRIBUTIONS UNDER 409A?

Generally, a principal purpose behind Code Section 409A and the regulations under that section is to prevent the employer and employee from manipulating or having discretion over the time of payment of deferred compensation. Payments generally can only be made upon a specified date, separation from service, death, disability, unforeseeable emergency, or a change in control.

Consequently, the final regulations carefully define when an employee separates from service, thereby triggering a distribution.

Under Treas. Reg. § 1.409A-1(h), a termination of employment is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that (1) no further services would be performed after a certain date, or (2) the level of bona fide services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed over the immediately preceding 36-month period (or the full period of services to the employer if the employee has been providing services to the employer is less than 36 months).

Facts and circumstances to be considered in making that determination include, but are not limited to, whether the employee continues to be treated as an employee for other purposes (such as continuation of salary and participation in employee benefit programs), whether similarly situated service providers have been treated consistently, and whether the employee is permitted, and realistically available, to perform services for other service recipients in the same line of business.

Importantly, the regulations establish certain presumptions regarding when separation has occurred:

1. A presumption that a separation from service *has* occurred where the level of bona fide services performed decreases to a level equal to 20 percent or less of the average level of services performed by the employee during the immediately preceding 36-month period.

2. A presumption that an employee CDs *has not* separated from service where the level of bona fide services performed continues at a level that is 50 percent or more of the average level of service performed by the employee during the immediately preceding 36-month period.

3. *No* presumption as to whether an employee separated from service if the decrease in the level of bona fide services performed is to a level that is more than 20 percent and less than 50 percent of the average level of bona fide services performed during the immediately preceding 36-month period.

Unfortunately, the regulations do not provide clear examples of how to measure services for purposes of these percentage tests.

A presumption that a separation from service has not occurred is rebuttable by demonstrating that the employer and the employee "reasonably anticipated" that as of a certain date the level of bona fide services would be reduced permanently to a level less than or equal to

the 20 percent level. The regulations provide as an example of "reasonably anticipating" that an employee would not perform services in the future where, after the original cessation of services, the termination of the employee's replacement caused the employee to return to employment.

A plan may also treat as a separation from service another level of reasonably anticipated permanent reduction in the level of bona fide services greater than 20 percent but less that 50 percent, provided that the percentage level of reduction required is specified in writing.

A difficulty may arise when, as has been common in the past, employers and employees enter into separation agreements which provide that a certain specified date is the date the employee is considered to have terminated employment. It is also common for those dates to not necessarily relate to when the employee actually ceases to perform services for the employer. For example, the date might be chosen in order to continue to provide salary or employee benefits for an extended period as a form of severance, long after the employee has actually ceased performing services. Or the date might be chosen in order to begin treating the employee as terminated even though the employee (perhaps now an independent contractor) continues to provide substantial (e.g., at a more than a 20 percent level) services, such as by training a replacement. In such cases, the date when a separation from service occurs for purposes of triggering payment of any deferred compensation subject to 409A (which may include certain severance amounts) may not be the same as the date of termination of employment as defined in the agreement. Caution needs to be exercised in drafting such separation agreements so that any payments subject to 409A that are to be paid on a separation from service will be paid on the actual separation from service under 409A if that is different than the termination date specified in the agreement.

LEAVES OF ABSENCE

Under the final regulations, the employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other bona fide leave of absence if:

- The period of leave does not exceed six months (29 months if due to disability or impairment that can be expected to result in death or to last more than six months), and

- There is a reasonable expectation that the employee will return to perform services for the employer.

If the period of leave exceeds six months and the individual does not retain a right to reemployment under an applicable statute or by contract, a separation from service is deemed to occur on the first date immediately following such six-month period.

Employers should review their leave of absence policies to determine when a leave might result in a separation from service triggering any 409A distributions.

OFFSET PROVISIONS

In the past, it has not been uncommon for executive deferred compensation arrangements, particularly those similar to severance arrangements, to provide that benefits would be offset by certain other benefits paid upon separation from service. However, the final regulations preclude many such offsets.

Treas. Reg. § 1.409A-3(f) provides that:

> ...the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation. A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of the compensation, but there is no forfeiture or voluntary relinquishment for this purpose if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount. Whether a payment or a right to a payment acts as a substitute for a payment of deferred compensation is determined based on all the facts and circumstances. However, where the payment of an amount results in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation, or if the service provider receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan, the payment or loan is a substitute for the deferred compensation... Even where there is no explicit reduction or offset, the payment of an amount or creation of a new right to a payment proximate to the purported forfeiture or voluntary relinquishment of a right to deferred compensation is presumed to be a substitute for the deferred compensation. The presumption is rebuttable by a showing that the compensation paid would have been received regardless of the forfeiture or voluntary relinquishment of the right to deferred compensation.

Though the presumption that the other payment is an impermissible substitute is rebuttable, it may be advisable to eliminate such offset provisions, or otherwise to coordinate them with specific offset amounts under which the timing or form of payment is not changed, so that even if the offset were to be considered a "substitute" and a payment of the compensation, it will not be a payment in a time or form that would violate 409A.

THE IMPACT OF EARLY VESTING ON PLANS RELYING ON THE "SHORT TERM DEFERRAL" EXCEPTION

A number of types of deferred compensation arrangements, such as bonuses and restricted stock units, rely on the so-called "short term deferral" exception of the regulations under which amounts must be paid out no later than 2½ months into the taxable year following the taxable year in which the compensation vests (i.e., is no longer subject to a substantial risk of forfeiture). However, it is also not uncommon for bonuses and other types of compensation to vest upon attainment of a retirement age. Caution should be exercised in drafting such short term deferral arrangements so that compensation that vests early because of attainment of retirement eligibility is paid within the short term deferral period, or all distribution provisions are made 409A compliant.

USE OF 409A "CATCH-ALL" CLAUSES

Another feature found in some deferred compensation arrangements is to have a catch-all provision to the effect that if any provision of the arrangement is subject to Code Section 409A, then all amounts will be paid in some manner intended to be compliant with 409A. However, these provisions should not be used as a substitute for carefully designing and drafting arrangements so that it is relatively clear whether the deferral is subject to 409A and how it will be paid. This is because, in the absence of doing so, the "catch-all" provision may be disregarded. As the Service warns in the final 409A regulations, "[f]or purposes of determining the terms of a plan, general provisions of the plan that purport to nullify noncompliant plan terms, or to supply any specific plan terms required [by the 409A regulations] are disregarded." Treas. Reg. § 1.409A-1(c)(1).

WHEN IS "FAIR MARKET VALUE" MEASURED FOR PUBLICLY TRADED STOCK RIGHTS?

The final regulations provide an exemption from 409A for some types of stock options and stock appreciation rights. We will not review

those in detail, but it is generally required by the regulations that they not be issued with an exercise price which is less than "fair market value" at the date of grant, that is, not "in the money."

For stock readily tradable on an established securities market, the fair market value of the stock may be determined based upon:

- The last sale before or the first sale after the grant,
- The closing price on the trading day before or the trading day of the grant,
- The arithmetic mean of the high and low prices on the trading day before or the trading day of the grant,
- Any other reasonable method using actual transactions in such stock as reported by such market, or
- An average selling price during a specified period that is within 30 days before or 30 days after the applicable valuation date, provided that the program under which the stock right is granted, including a program with a single participant, must irrevocably specify the commitment to grant the stock right with an exercise price set using such an average selling price before the beginning of the specified period.

In drafting stock-based rights based on publicly traded stock which are intended to meet the exemption from 409A, care must be taken to use one of these methods for determining fair market value. Change in control agreements should in particular be carefully reviewed, as these sometimes provide special rules for determining payout value (indirectly affectingthe exercise price) in the event of a change in control that may not comply with the 409A regulations.

TAXABLE HEALTH CARE BENEFITS

The definitions under the final regulations provide that the term "nonqualified deferred compensation plan," for purposes of such plans being subject to 409A, does not include a medical reimbursement arrangement, including a health reimbursement arrangement, which satisfies the requirements of Section 105 and Section 106 such that the benefits or reimbursements provided under such arrangement *are not includible in income*. Most such benefits are intended to be nontaxable, of course, but it may be advisable for employers to take a closer look at

their self-insured health plans to ensure that is so. Of particular concern are the longstanding nondiscrimination requirements of Code Section 105(h). If not met, Code Section 105(h) can cause some benefits to be taxable, implicating 409A.

To pass the nondiscrimination tests under Code Section 105(h), a self-insured medical plan must pass both an "eligibility test" and a "benefits test." For the eligibility test, the plan cannot discriminate in favor of highly compensated individuals ("HCIs") as to eligibility to participate. For the benefits test, benefits for HCIs must be provided on the same basis to all other participants. An individual is generally an HCI for purposes of applying these rules if he or she is: (1) one of the five highest paid officers, (2) a shareholder who owns more than 10 percent in value of the stock of the employer, or (3) among the highest paid 25 percent of all employees (including the five highest paid officers but disregarding nonparticipating excludable employees; excludable employees who participate in the plan must be included).

This article will not go into detail as to how the 105(h) nondiscrimination tests work, but the eligibility test applies certain percentage tests to the proportion of employees participating in the arrangements, or in the alternative is satisfied by covering a nondiscriminatory classification of employees. The benefits test requires the plan to satisfy the following criteria:

- All benefits provided to HCIs who participate must be provided on the same basis to all other participants, and

- All benefits available for the dependents of HCIs must be available on the same basis for the dependents of non-HCI participants.

The consequence of failing to satisfy the nondiscrimination rules of Code Section 105(h) is that all or a portion of the medical reimbursements of HCIs are included in their gross income. And this, in turn, could result in the health plan coverage to affected HCIs being subject to Section 409A.

In addition to general 105(h) nondiscrimination concerns, particular issues may arise in promising additional health benefits to only certain employee under a self-insured arrangement, for example, in an HCI's executive termination agreement or in a reduction in force.

For example, the regulations under Section 105(h) provide that:

> A plan may establish a maximum limit for the amount of reimbursement which may be paid a participant for any single benefit, or combination of benefits. However, any

> maximum limit attributable to employer contributions must be uniform for all participants and for all dependents of employees who are participants and may not be modified by reason of a participant's age or years of service. In addition, if a plan covers employees who are highly compensated individuals, and the type or the amount of benefits subject to reimbursement under the plan are in proportion to employee compensation, the plan discriminates as to benefits.

Treas. Reg. § 1.105-11(c)(3)(i).

The benefits test applies to retirees if an HCI who is a retired employee does not receive the same type or dollar limitations of benefits as are provided to other retired participants. The regulations under Section 105(h) state that:

> To the extent that an employer provides benefits under a self-insured medical reimbursement plan to a retired employee that would otherwise be excludible from gross income under section 105(b), determined without regard to section 105(h), such benefits shall not be considered a discriminatory benefit under this paragraph (c). The preceding sentence shall not apply to a retired employee who was a highly compensated individual *unless the type, and the dollar limitations, of benefits* provided retired employees who were highly compensated individuals are the same for all other retired participants. [emphasis added]

Treas. Reg. § 1.105-11(c)(3)(iii).

Some older private letter rulings, though not technically precedent, suggest these rules pose an issue if HCIs are offered lower premiums for coverage than non-HCIs, or coverage under different terms. *See, e.g.,* PLRs 8343069, 8328065, and 8342127. In PLR 8342127, the Service stated that "it is the position of the Internal Revenue Service that the survivor of a highly compensated individual may, if benefits are made available to such survivor in excess of those made available to similarly situated survivors of other participants, be in receipt of excess reimbursement. Such situation could arise *if the contributions required* of a survivor result in the survivors of highly compensated individuals being able to continue coverage in a manner that discriminates in their favor, as opposed to the survivors of other participants." [emphasis added]

Also concerning are Private Letter Rulings 8411051 and 8411050. Those PLRs, which are substantially similar, do not involve different premiums paid by HCIs, but a situation where coverage was immediate

for one class of HCIs while it was available only after 90 days for the other non-HCI class. Under those facts, the IRS treated reimbursements to HCIs during the 90 days as taxable under 105(h).

Accordingly, employers with self-insured health care plans may wish to review their plans, and any special extensions of benefits or payment of premiums for retirees, for compliance with 105(h) to ensure compliance with 409A.

TCN PLANS AND US EMPLOYEES

Another concern can arise in nonqualified plans covering "third country nationals," usually meaning non-US employees who are working and resident outside of both their country of citizenship and the US. These are often referred to as "TCN" plans. Generally (though not always) these plans are unfunded. They are also generally not designed to cover aliens who are resident in the US or US citizens as participants. But it can happen inadvertently, particularly where administration takes place outside the US and the plan administrator is not watching for US tax issues, and it then introduces the question of application of Section 409A to the plan. For a typical TCN plan, the exemptions under 409A, if it needs one for a US citizen or resident, are few. One which may sometimes apply is where the individual was a nonresident alien when the compensation vested. For example, if a foreign citizen works outside the US and then retires to the US, the compensation deferred and vested while working in the foreign country generally will not be subject to 409A. In addition, if the plan covers US taxpayers and is funded for tax purposes so that contributions and earnings are currently taxed as vested each year, the plan may avoid the application of 409A as well. If not, though, for US taxpayers, the TCN plan must comply with 409A, at least for those US taxpayers. Other 409A exemptions apply to certain "corresponding" foreign plans under tax treaties and broad-based foreign plans, but those are subject to many limitations that must be carefully examined and in many cases can make it difficult to fully escape 409A.

Of course, if the plan covers US citizens or nonresident aliens and is not a "top hat" plan, it may also fail to meet the exemption for foreign plans from ERISA under ERISA Section 4(b)(4). The ERISA 4(b)(4) exemption does not apply if the plan is either not "maintained outside the US" or if less than "substantially all" of its participants are nonresident aliens. The most straightforward manner for a TCN plan to operate is to cover no US citizens or US residents. Current authority has generally suggested that in that event, minimal US plan administration may have little impact on the ERISA status of the plan. However,

if any US citizens or residents become plan participants, it would be advisable for the employer to take measures to ensure that the plan is clearly maintained outside the US.

A FINAL WORD ON CORRECTIONS

Though the IRS has issued guidance that permits certain unintentional operational violations of Section 409A to be corrected, and generally applies only to corrections in the year of failure and certain other years, or of limited amounts. Other types of operational violations not covered by the guidance generally cannot be corrected. Nor is there any correction program for plan document failures. In those cases, the draconian tax treatment generally applicable to 409A violations will apply. And to make matters worse, the failure under one plan can affect all plans of the same type for an employee, so that failure under one plan can have a "cascading" effect.

For these reasons, employers need to be diligent regarding 409A compliance. While inadvertent and obscure technical 409A errors may seem sympathetic cases, the political atmosphere surrounding executive compensation suggests that the IRS will show little leniency to highly compensated executives who violate its terms.

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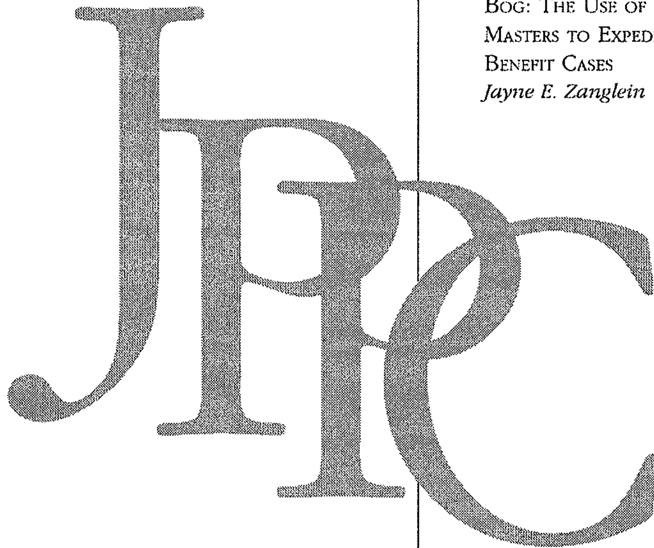

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