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An Analysis of Recent Developments & Trends

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Section 409A Broadly Impacts Employment Agreements, Severance Arrangements and Settlement Agreements

by: Steven J. Friedman, J. René Toadvine, and Russell D. Chapman

Summary: Section 409A of the Internal Revenue Code imposes wide-ranging restrictions in connection with many pay arrangements that in one form or another, defer compensation. These include many types of payments under employment agreements, severance arrangements and agreements to settle litigation. A great number of existing arrangements will need to be amended in 2007 in order to remain compliant with the law.

Many employment law attorneys and human resource professionals are surprised to learn that section 409A of the Internal Revenue Code ("Section 409A"), which was enacted to curb abuses related to deferred pay arrangements for high-ranking executives, also impacts arrangements that defer pay only incidentally and arrangements that are broad based across an employee population. This Insight discusses how Section 409A affects employment agreements, severance arrangements and settlement agreements, how employers can utilize exceptions built into the rules to sidestep the restrictions imposed by Section 409A and the necessary steps that employers must implement in order to comply with these rules.

What Does Section 409A Regulate?

Section 409A essentially regulates any arrangement that defers compensation. Simply put, a deferral of compensation exists if a service provider (generally an employee) obtains a "legally binding right" to compensation in one year that is then paid in a later year. A legally binding right exists even if the payment of the compensation is conditioned on the future performance of services or other conditions established by the employer (such as a financial goal of the employer being met). There is no deferral of compensation, however, where an employer has an unfettered right to reduce or eliminate the compensation.

Deferred compensation can thus be created in many ways under employment agreements, severance arrangements and settlement agreements. Under an employment agreement there may be a promise to pay an employee a certain sum if he or she works for an employer for a requisite period or if a financial goal is

met. A severance plan or other agreement may provide for the payment of a certain amount in the event that certain events transpire. Similarly, a severance deal or an agreement to settle a lawsuit, which is negotiated with an employee upon his or her departure, may create deferred compensation if payments are made beyond the current calendar year. Therefore, employment lawyers and human resources professionals should be on guard to make certain that if an arrangement creates deferred compensation, the appropriate steps are taken to deal with the consequences of Section 409A.

What Does Section 409A Require?

With respect to the types of arrangements being discussed in this article, Section 409A regulates the time and form of distribution. Distributions may only take place upon the occurrence of certain events or at times specified in the arrangement. Accordingly, if an arrangement is subject to Section 409A, the time and form of payout cannot be manipulated or changed, except in narrow circumstances. Also, if a payment of deferred compensation is made to a "specified employee" of a publicly held company, on account of that employee's separation from service, the payout must be delayed for six months following the date of termination. The rules for determining who is a "specified employee" are rather complex, but generally this group comprises the top 50 officers (earning at least \$145,000 in 2007). An entity need not be traded in the United States to be a publicly traded company for purposes of this rule; it can be traded anywhere in the world and the determination of who is a specified employee is made on a "controlled group" basis.

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The consequences of running afoul of Section 409A can only be described as draconian. The penalties for noncompliance are immediate income taxation of all amounts deferred under the agreement (even if not yet payable), and a 20% penalty tax, both of which are assessed on the employee who has earned the compensation. Interest is assessed at a "nonpayer rate" (which is higher than that imposed for other violations) plus 1%. If the employer tax-protects the employee on the taxes and penalty, then interest and an additional 20% penalty is assessed on any tax-protection payments, and the tax-protection payment is not deductible by the employer.

The balance of this article discusses how Section 409A regulates the "time and form of distribution" requirements, the exceptions to Section 409A and action steps for employers to take in 2007.

Time and Form of Distribution Rules for Arrangements Governed by Section 409A

Pursuant to Section 409A, deferred compensation may be distributed no earlier than upon one of the following distribution events:

- Separation from service
- Disability
- Death
- A specified time (or pursuant to a fixed schedule) set forth in the plan
- Corporate change in control
- Unforeseeable emergency

The arrangement must specify the distribution events in advance, and distributions may not be accelerated.

It is important to note that under Section 409A, a distribution does not have to be made immediately upon the occurrence of a permitted distribution event, but instead, can be made at a time fixed by reference to a permitted distribution event (e.g., three months after separation from service). In addition,

the distribution will be deemed to have been made on a timely basis if it is made within the same calendar year or, if later, by the 15th day of the third month following the distribution date specified by the plan. Further, a distribution made no earlier than 30 days prior to the designated distribution date is also permitted. If the plan specifies that distribution will occur within a specified period (e.g., within 60 days following a distribution event), the distribution will be deemed to have been timely made if distribution occurs within the period and the period begins and ends within the same tax year or the period does not exceed 90 days.

Generally, only a single time and form of distribution may be designated for each distribution event, with two exceptions:

1. with respect to a distribution that occurs upon an event other than separation from service or at a fixed time/schedule, a plan may provide for a different time and form of distribution for a distribution event occurring before or after a specified date; and
2. with respect to distribution that occurs upon separation from service, a plan may provide for a different time and form of distribution with respect to a separation from service that occurs:
 - a. within two years after a change in control; or
 - a. before or after a specified date, a specified age or a specified combination of date and age.

Separation from Service

Generally, separation from service occurs upon an employee's death, retirement or other termination of employment with the employer. If an employment agreement or separation arrangement provides for a payment upon a "separation from service," either the failure to make a payment upon a Section 409A separation or a payment triggered where there has been no Section 409A separation

could cause an excise tax to be triggered. The final regulations provide guidance as to when an employee on an approved leave of absence will be treated as having incurred a separation from service (generally, the day after a six-month leave (or longer period if the employee's right to reemployment is a longer period as required by applicable law)). Additional rules apply for purposes of determining whether an employee whose work schedule has been reduced has incurred a separation from service. If the level of service drops to 20% or less of the average level of service performed during the immediately preceding 36-month period, the employee is presumed to have separated from service. If the level of service drops to a level that is 50% or more of the average level of service performed during the immediately preceding 36-month period, the employee is presumed not to have separated from service. No presumption applies where the level of service is more than 20% but less than 50%.

If an employee is a "specified employee" at the time of distribution and is to receive a distribution as a result of a separation from service, distribution generally may not be made until at least six months following the separation from service. Significantly, this "six month hold" must be provided in governing documents; if it is needed but not contained in the documents, no hold may be implemented and a 409A violation will occur.

For these purposes, *specified employee* is defined as an employee of a publicly traded employer (on a controlled group basis) who: (1) owns more than 5% of the employer; (2) owns more than 1% of the employer and has annual compensation greater than \$150,000; or (3) is an officer of the employer whose annual compensation is greater than \$145,000 (2007, indexed for inflation). Officer status is based on job duties, not title, and is limited to the 50 highest-paid officers.

An employer must determine its group of specified employees as of a uniform identifi-

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cation date each year (generally, December 31). The determination generally does not take effect until the beginning of the 4th calendar month following the identification date, with the identified employees remaining as specified employees for the next 12 months. For administrative convenience, an employer may use alternative methods for identifying specified employees provided the method used: (1) is reasonably designed to include all employees that would be specified employees under the statutory rule, above; (2) is an objectively determinable standard that does not provide the employee with any election rights; and (3) results in no more than 200 employees being identified as specified employees as of any date.

The final regulations also provide rules for determining specified employees as a result of a corporate transaction.

Disability

409A provides two different definitions of disability. In addition, the final regulations allow a plan to deem an employee to be disabled if such employee is totally disabled for purposes of receiving Social Security disability benefits. Further, an arrangement may deem an employee disabled if the employee is disabled pursuant to a disability insurance arrangement sponsored by the employer, provided such determination is at least as restrictive as the definition of disability set forth in Section 409A. Employment agreements and other pay-deferral devices may need to be amended to provide for a Section 409A-compliant definition.

Death

Upon death, deferred compensation generally may be distributed by the end of the calendar year of death or, if later, by the 15th day of the third month following death.

Fixed Time or Fixed Schedule Set Forth in the Arrangement

A plan or arrangement may provide that distribution of deferred compensation will occur

on a fixed date, during a specified year or, in the case of installment or annuity forms of distribution, pursuant to a fixed schedule. A distribution date is fixed if it is nondiscretionary and objectively determinable at the time compensation is deferred.

Reimbursement of certain expenses or the provision of in-kind benefits will be deemed to be made pursuant to a fixed time or schedule if the plan:

- provides an objectively determinable non-discretionary definition of the benefits;
- specifies an objectively prescribed payment period;
- states that benefits paid in a given year will have no effect on benefits payable in another year; and
- precludes benefits from being exchanged for another benefit or for cash. In addition, reimbursement of expenses must be made no later than the end of the tax year following the tax year in which the expenses were incurred.

Tax gross-up payments will also be deemed to be made pursuant to a fixed time or schedule if the plan states, and payments are made, no later than the end of the tax year following the tax year in which the taxes giving rise to the gross-up payments are paid.

Change in Control

Many employment agreements provide for a payout of deferred compensation upon a change of control. Employment agreements and other pay-deferral devices should be reviewed to make certain that the time for payout is fixed and incapable of manipulation by either the employer or employee. Section 409A provides three types of change in control that may result in a permissible distribution: change in ownership, change in effective control and change in ownership of a substantial portion of corporate assets. A plan may provide for a more restrictive definition of change in control, but may not distribute deferred compensation based on a

less restrictive definition of change in control. However, in a “double trigger” situation (*i.e.*, where distribution occurs only after separation from service following a change in control), a plan’s definition of change in control is not required to satisfy Section 409A’s definition since it is the subsequent separation from service, not the change in control, that triggers distribution. With respect to “single trigger” change of control provisions, a revision may need to be made to the arrangement to ensure that the arrangement’s definition of change in control is consistent with Section 409A’s requirements. Section 409A’s change-in-control rules address corporate transactions only; however, pending further guidance, taxpayers may apply the corporate transaction rules to noncorporate transactions by analogy.

Unforeseeable Emergency

Section 409A permits an arrangement to distribute deferred compensation upon an unforeseeable emergency, which is defined to be a severe financial hardship arising from: (1) illness or accident of the employee, the employee’s spouse, or the employee’s dependents; (2) casualty loss; or (3) other similar extraordinary or unforeseeable circumstances arising as a result of events outside the employee’s control. A hardship is deemed not to exist if it can be relieved by reimbursement or compensation from insurance or otherwise, by liquidation of the employee’s assets (to the extent the liquidation does not cause a hardship). The amount distributed cannot exceed the amount necessary to relieve the hardship.

Changes in Time and Form of Distributions

Under Section 409A, an employee may not accelerate the timing of a distribution of deferred compensation. However, if permitted by the plan, an employee may delay distribution of the employee’s deferred compensation if the election to delay payment is made at least 12 months prior to the date the payment is otherwise scheduled to be made, the election is not effective for at least 12 months

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following the date the election is made and, with respect to distributions other than on account of death, disability or unforeseeable emergency, the distribution commencement date is delayed for at least five years from the date the payment would have otherwise been made. What constitutes a "payment" depends on the plan's terms. For example, with respect to a series of installment payments, but not an annuity stream, an arrangement may treat the entire series as a single payment or each installment as a separate payment. If the entire series is treated as a single payment, the series may be converted to a lump sum, provided the change in election is made at least 12 months in advance of the scheduled commencement of the installment payments and the lump sum does not become payable until at least five years after the date the initial installment payment was to be made. In such an event, the distribution will also be deemed not to violate the anti-acceleration rule. However, if each installment is treated as a separate payment, the series of payments cannot be converted to a lump sum; but, individual installments may be delayed if elected in a manner that complies with the 1-year/5-year rule, above.

Substantial Risk of Forfeiture

Under Section 409A, deferred compensation is subject to a substantial risk of forfeiture if the receipt of deferred compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation and the possibility of forfeiture is substantial. Noncompete agreements within employment agreements or severance arrangements do not create a substantial risk of forfeiture. Further, the addition of any risk of forfeiture or extension of an "at risk" period is disregarded once a legally binding right to compensation arises. Finally, elective deferrals of compensation cannot be subject to a substantial risk of forfeiture unless the amount subject to risk is materially greater than the amount that is electively deferred.

The determination of whether deferred compensation is subject to a substantial risk of forfeiture is important for purposes of the application of the short-term deferral rule, as the rule requires that payment be made within 2 1/2 months following the year in which the amount to be paid is no longer subject to a substantial risk of forfeiture.

Exceptions to Section 409A Rules

There are a number of compensation arrangements that are not subject to Section 409A under the final regulations. However, these excluded arrangements may be subject to strict and in some cases complex requirements. The consequences of misapprehending a Section 409A deferred compensation plan may be so severe that extreme caution and care are advised if any of the Section 409A exclusions are to be relied upon. If time and circumstances permit, it may be advisable to obtain a private letter ruling on the issue of whether a particular plan is covered by Section 409A or fits within the intended exception. If obtaining a ruling is not possible, then extreme vigilance in following the exclusion requirements in the regulations should be observed.

Short-Term Deferrals Exclusions

A very common exclusion from the Section 409A regulations is the exclusion for "short-term deferrals". If a payment constitutes a "short-term deferral," it simply will not provide for deferred compensation.

A short-term deferral is one which is paid under an arrangement on or before the 15th day of the third month following the employee's taxable year (or if later, the 15th day of the third month following the employer's taxable year) in which the amount is not subject to substantial risk of forfeiture. For virtually all individual taxpayers, this date will be March 15 of the following year. So, if a severance arrangement provides for a payment that will not be made until March

1 of the year following the year in which an employee's involuntary termination of employment occurred, that payment is a "short-term deferral" that will be excluded from Section 409A's rules because it is paid by March 15 of the year following the year containing the "vesting" date which, in this case would be the employee's involuntary termination date.

Significantly, in order to take advantage of the short-term deferral exception, the compensation must not only be paid out within the short-term deferral period, it also must be impossible for a payment to be made after this period ends. For instance, suppose an employment agreement provides that payment of a \$50,000 deferred bonus will be made to the employee upon termination, but that the employee will not be entitled to the payment until after three years of continued employment. This could not be a short-term deferral under Section 409A even if the employee quits right after becoming vested in the payment after working three years because the employee could work many more years and not receive the payment until after the short-term deferral period ended.

Another important element of the short-term deferral rule is that, as described above, an employer has the option of specifically providing that each of a series of installment payments will be considered separate payments under an arrangement. This designation would permit an employee to consider each specific installment payment that he or she receives as a short-term deferral if the requirements of this exception are met with respect to such payment. If no such designation is made, no portion of a series of installment payments that ends after the end of the short-term deferral period could be considered to consist of a short-term deferral. The employer's designation of a series of payments as separate payments must be in place at the time the compensation is deferred. A special rule permits the designation to be made by the end of 2007 for existing arrangements.

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Delay Due to Administrative Feasibility, Financial Inability or Excessive Compensation

As long as the payment is properly documented and designated as a short-term deferral it will enjoy exemption, even if payment is delayed past the applicable 2 1/2 month period where making the payment earlier is administratively impracticable due to unforeseen circumstances, where making the payment before the date designated in the plan would subject the payor to financial jeopardy, or where making the payment on time would have unforeseeably rendered the payment nondeductible as excess compensation under Internal Revenue Code ("Code") section 162(m). On a practical basis, this means with respect to any arrangement that defers compensation, where there is an intent to make a payment within the short-term deferral period, an employer should consider providing in writing that the payment will be made during that timeframe. This way, if a payment of deferred compensation is paid beyond this short-term deferral period, it may not be a violation of Section 409A.

Also, where it is reasonably anticipated that the compensation payable during any given year will exceed the Code section 162(m) limitation, it may be wise to require in the arrangement that any portion of the compensation payable by the end of the applicable 2 1/2 month period, which would exceed the deductible limit of "reasonable compensation," be automatically deferred into the first 2 1/2 months of the following calendar year.

Separation Payment Designation

Generally, compensation that would otherwise be "deferred compensation" under the final regulations will not escape that treatment merely because separation from service is a trigger for those payments. However, the regulations provide a series of four exemptions from "deferred compensation" treatment where the compensation is paid under a separation pay plan.

Separate consideration of each separation pay plan exemption. Under the separation pay plan exemptions described below, each payment is analyzed under each of the four exemption categories *ad seriatim*, and the exemptions are applied one by one to determine if the payment is exempt. This method of analysis effectively gives the employer four bites at the exemption apple. Thus, if the first exemption does not apply, the next is examined independently, and the chances of the individual payment being exempt increases.

Separation pay to offset counterpart forfeiture could result in disaster. However, note that notwithstanding the "stacking" concept, the regulations provide that if a payment is due under a separation pay plan, but due to the separation, another identical or closely similar payment is forfeited under another deferred compensation plan, the separation pay plan payment may not only lose its exemption as a separation pay plan, but it also may be considered an impermissible acceleration under the other plan by virtue of serving as an impermissible replacement or substitute for the forfeited plan payment. If the separation is voluntary, substitution will be presumed; otherwise, substitution is determined according to the facts and circumstances of each case. One "factor" that can rebut the presumption that arises in a voluntary separation is whether the separation plan payment is materially less than the forfeited amount.

Except for "window program" terminations, "good reason" terminations, and foreign separation pay plans, discussed below, separation plan payments and voluntary resignations are like oil and water. They simply will not mix under the regulations. Generally, separation pay that is due upon voluntary separation will be subject to Section 409A.

The Separation Pay Plan Exemptions:

The separation pay plan exemptions are generally:

1. collectively bargained ("CBA") separation pay plans;
2. involuntary separation or window program plans;
3. foreign separation pay plans; and
4. separation expense reimbursements and other payments.

CBA Separation Pay Plan

A separation pay plan under a CBA will be treated as an exempt separation pay plan if it: (1) is contained in a collective bargaining agreement as determined by the Secretary of Labor; (2) the CBA was the result of arm's length negotiations between employee representatives and one or more employers, satisfying Code section 7701(a)(46); and (3) the separation pay was the subject of good-faith bargaining between adverse parties.

Involuntary Separation or Window Plans

Separation pay plans other than CBA plans providing for separation pay only upon involuntary separation from service (defined below), or those plans pursuant to a *window program* ("involuntary separation plans"), are exempted from the Section 409A rules to the extent the separation pay, or a portion thereof, meets certain requirements.

A *window program* for purposes of the regulations is a program whose purpose is to make separation pay available to employees who apply to the employer under the program during a limited period of time of not more than 12 months and who separate during that period whether or not additional requirements are specified by the program.

If the employer has a pattern of providing window programs on a more or less periodic basis, the program will lose the exemption. Whether a pattern of providing window programs exists will be determined on a facts and circumstances basis. Some of the factors that the Internal Revenue Service will consider in determining whether a pattern has been established is whether the window

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program relates to a specific business event or condition, and the degree to which the separation payments relate to such event or condition, and whether the event or condition is isolated or merely a permanent feature of the employer's on-going business.

The involuntary separation pay plan requirements are:

1. The separation pay under the plan does not exceed two times the lesser of:
 - a. employee's annualized rate of compensation for the employee's taxable year preceding the separation; or
 - b. the maximum "compensation" limitation for qualified plans (for 2007, this limit will be \$450,000); and
2. The separation pay must be paid not later than the later of the last day of the employee's or employer's second taxable year after the separation.

Time Limitation

The entire separation pay must be paid not later than December 31 of the second year after the year in which the separation occurred.

Involuntary Separation from Service Defined

Involuntary separation from service occurs only when the employer exercises its "unilateral authority" to terminate the employee's services, except in "walking the plank" situations, such as where an employee resigns in lieu of being fired. Generally, determining whether the separation was voluntary is determined according to the particular facts and circumstances, and if the employee signs a document indicating that the separation was voluntary, then a rebuttable presumption arises that it was.

Foreign Separation Pay Plans

Separation pay will be exempt from the requirements of Section 409A to the extent it is required under a provision of foreign

law, even if the payments are upon voluntary separation. Generally, a foreign separation pay plan will only apply to foreign earned income as defined in Code section 911(b)(1), but without the exclusion for amounts paid after the close of the taxable year in which the services were performed to which the amounts relate.

Separation Reimbursement Payment Plans

Payments made under a separation reimbursement plan as part of a separation pay plan are also excluded from the Section 409A requirements. Excluded separation reimbursement payments are reimbursement of expenses incurred by the employee that would otherwise be deductible as reasonable trade or business or reasonable outplacement or moving expenses under Code sections 162 or 167. They must be related to the separation and based on a right of reimbursement arising under the arrangement for a limited period of time in order for the exclusion to apply. Medical benefits reimbursed under the arrangement must qualify as deductible under Code section 213 (but disregarding the 7.5% of adjusted gross income limitation) and, to the extent the rights apply during the COBRA group health plan continuation period, applicable to the employee. In-kind benefits, such as outplacement services, are treated as exempt from the Section 409A requirements if a reimbursement directly to the employee would be exempt under the same circumstances.

The regulations also provide for a right of reimbursement of incidental expenses in an amount not in excess of the annual limitation on elective deferrals under a 401(k) plan.

Generally, the right of reimbursement is exempt from the Section 409A rules to the extent the right to incur reimbursable expenses does not extend beyond the last day of the employee's second taxable year following the year of the separation, and the right of reimbursement for those expenses does not extend beyond the third such taxable year.

Good Reason Terminations

A "good reason" termination is a termination of employment initiated by an employee as a result of the occurrence of an enumerated event. Many employment agreements and severance plans contain provisions that treat "good reason" terminations in a fashion similar to involuntary terminations. However, under 409A, a "good reason" termination may be deemed to be voluntary or involuntary. The determination of whether a "good reason" termination is voluntary or involuntary is important for purposes of the application of both the short-term deferral rule and the severance pay exceptions. If the termination is deemed to be voluntary, the severance pay exception will not be applicable and, with respect to the short-term deferral rule, the amount to be paid upon such termination will be deemed to be no longer subject to a substantial risk of forfeiture as of the effective date of the agreement which contains the "good reason" clause, which starts the "clock" for purposes of the short-term deferral rule. However, if the termination is deemed to be involuntary, the severance pay exception may still apply to the distribution (assuming the other requirements necessary for such exemption are satisfied) and, for purposes of the short-term deferral rule, the existence of the "good reason" termination clause will not result in a lapse of any substantial risk of forfeiture that may otherwise exist.

The final regulations allow employers to treat certain "good reason" terminations as constituting involuntary terminations. First, the final regulations provide for a facts and circumstances test for determining whether an involuntary termination has occurred, under which: (1) bona fide conditions equivalent to an involuntary termination must exist; and (2) the conditions must require action by the employer that results in a material adverse impact to the employee (e.g., job duties and compensation changes). Other factors to be considered include whether an employ-

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ee-notice and an employer-cure period are required and whether the compensation paid as a result of a “good reason” termination is equivalent to compensation to be paid on an actual involuntary termination. A “good reason” clause cannot be used in any way to avoid Section 409A with respect to amounts that are otherwise deferred compensation payable upon voluntary termination.

Second, the final regulations provide a “good reason” safe harbor that, if satisfied, is deemed to be an involuntary termination. Under the safe harbor, the following conditions must be satisfied:

1. The employee must terminate employment within a predetermined period of time (not to exceed two years following the initial existence of one or more of the following conditions that occur without the employee’s consent):
 - Material diminution in the employee’s base compensation;
 - Material diminution in the employee’s authority, duties or responsibilities;
 - Material diminution in the authority, duties or responsibilities of the employee’s supervisor;
 - Material diminution in the budget over which the employee retains authority;
 - Material change in the geographic location where the employee must perform services; or
 - Any other action or inaction that is a material breach by the employer of the agreement under which the employee performs services.
2. The amount, time and form of payment must be substantially the same as that to be paid upon an actual involuntary termination of employment; and
3. The employee must provide notice to the employer of the existence of the condition providing the basis for the potential “good reason” termination within 90

days after the condition arises, and the employer must be given at least 30 days thereafter to cure the condition.

Bona Fide Legal Settlement Agreements

Bona fide legal settlements of employment claims are also exempt from the requirements of Section 409A under the final regulations. A settlement may be based on claims related to any employment-related action such as wrongful termination, employment discrimination, a violation of the Fair Labor Standards Act, an action for benefits or for retaliation under a state workers’ compensation statute, or employment-related claims under any applicable federal, state, local, or foreign law. The settlement agreement may include payments for reimbursement of reasonable attorneys’ fees or other reasonable expenses incurred by the employee related to such bona fide legal claims.

However, caution is advised here. There may be a great temptation on the part of employee-plaintiffs to pressure employer-defendants to modify the timing or form of payment of deferred compensation that the employee had an preexisting right to receive by claiming that there is a disputed employment-related claim, which is then resolved under a settlement agreement providing for a materially similar deferred compensation award but with a modified form of payment. A settlement agreement that has the effect of impermissibly modifying an existing deferred compensation obligation will not be exempt from the Section 409A regulations even if a bona fide employment law claim is settled at the same time. In such a case, the modification of existing payout terms could cause a Section 409A violation through the effective substitution of a payment included in the settlement whose timing or form differs from that provided in the original deferred compensation agreement. Accordingly, settlement agreements that are intended to be exempt from the Section 409A rules should be limited to providing amounts that an employee

has no preexisting right to receive, and existing deferred compensation agreements should not be cancelled, waived or amended, either independently, or through the settlement agreement.

Accrual Basis Service Providers

The definition of *service provider* includes an individual, or any entity that would be a qualified personal service corporation if it were a corporation, that accounts for income for federal income tax purposes on the cash basis. Therefore, the Section 409A and the regulations, constituting as they do special timing rules, do not apply to an accrual basis taxpayer. In effect, the 409A rules place the taxpayer on an accrual basis with special penalty provisions – therefore there is no need for the rule in the case of accrual basis taxpayers.

Independent Contractors

The Section 409A rules do not apply to an independent contractor, as opposed to an employee or a member of the board of directors of a corporation, under a special independent contractor analysis provided under the Section 409A regulations. Under this special analysis, the service provider will not be subject to Section 409A if:

1. the individual does not perform services as an employee or a member of the board of directors (or an analogous position with a noncorporate entity);
2. the service provider provides significant services to at least two service recipients that are unrelated (both as to the service provider and as to one another) during the taxable year; and
3. the service provider is unrelated to the service recipient using a 20% test under the rules of Code sections 267(b) or 707(b)(1).

Whether a service provider provides “significant service” depends on the facts and

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circumstances, but it will generally be deemed the case if the service provider has not generated during the current or past three taxable years, or have reason to know that during the current taxable year, it will generate, 70% of its total revenue from any one recipient or related group of recipients. However, this exception will not apply if the provider provides "management services", defined as de facto direction or control over the operations of the recipient, or investment management advice or services with respect to an investment company.

Stacking of Exemptions

Central to the application of the exemptions is the "stacking" concept, or the ability of the parties to bifurcate the payments under the arrangement into a series of payments, each of which may in whole or in part, qualify for the exemption or not. Note that generally, the "stacking" concept will apply only if the payments under the plan at issue can be viewed as separate payments, as opposed to a single payment. Accordingly, where a specified employee would otherwise be subject to a six-month hold on a payout of deferred compensation payable in installment payouts (on account of his involuntary termination of employment) it may be permissible for an employer to: (1) designate each installment payment as separate payments; (2) consider each payment to be made by March 15 of the following year a short-term deferral; and (3) for payments to be made after March 15 of the following year, to consider whether any or all of such payments could qualify for the separation pay exemption described above.

The "stacking" concept may be lost if the plan under consideration is considered a subterfuge or an attempt to circumvent the Section 409A rules, for example, by creating a substitute for a forfeited amount under another deferred compensation plan, or by creating an impermissible acceleration of a payment deferred under another plan. Great care must be taken in the drafting of arrangements that are intended to be exempt from the

requirements of Section 409A and the regulations. If not, the exemption intended may be lost, and the consequences disastrous.

Transition Rules and Action Employers Must Take in 2007

December 31, 2007 Documentary Compliance Deadline

The regulations are effective January 1, 2008. However, employers must be in good faith compliance with the regulations prior to such time. Section 409A permits employers to amend all documents that may currently contain noncompliant provisions by December 31, 2007, to meet the requirements of Section 409A. Noncompliant distribution provisions may be changed to provide 409A-compliant provisions so long as this does not cause amounts to be: (1) deferred until a date later than December 31, 2007, if, in the absence of the amendment, payment would be made in 2007; or (2) accelerated into 2007 if the amount would otherwise be payable at a later date.

Significantly, the Section 409A rules permit employers to comply with section 409A by using more than one document for a single arrangement or payment. Thus, an employer can adopt "umbrella" documents that amend all plans of the same type or category to comply with Section 409A. Note that if the umbrella document amends a deferred compensation plan or an employment agreement that requires employee consent, the document will be subject to the signature acceptance of each affected employee.

Employer Action Items

There are several steps that employers should take currently to avoid the pitfalls contained in the Section 409A rules. These include:

- Creating an inventory of all arrangements that contain "deferred compensation."
- Determine which of these arrangements are subject to the Section 409A rules.

- Ascertain whether arrangements are in current operational compliance.
- Amend all noncompliant arrangements by the end of 2007.
- Consider the adoption of "umbrella documents" in 2007, which will contain omnibus Section 409A language for all similar arrangements.
- Consider how the various exceptions to Section 409A can be used such as designing installment payments as separate payments, "stacking" more than one exception on the same arrangement and taking advantage of the separation pay plan exemptions. Employers should then provide appropriate language in these documents to maximize the use of these exceptions.

Steven J. Friedman is Chair of Littler Mendelson's Benefits Practice Group and a Shareholder in the New York office. J. René Toadvine is a Shareholder in Littler Mendelson's Charlotte office. Russell D. Chapman is Of Counsel in Littler Mendelson's Dallas office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Mr. Friedman at sfriedman@littler.com, Mr. Toadvine at rtoadvine@littler.com, or Mr. Chapman at rchapman@littler.com.
