EXECUTIVE COMPENSATION: MUCH TO DO ABOUT . . .

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I. INTRODUCTION

With the turn of the millennium there is an ever-increasing focus on executive compensation, ranging from jawboning on the part of politicians to the enactment of criminal sanctions for some executive compensation arrangements. The adventures into executive compensation are wide ranging; one might apply the appellation of helter-skelter.[1] It is difficult to predict what will survive and/or be enacted in connection with the current discussions targeting executive compensation. However, it seems unlikely that, in the near term, the intensity of the heat in the kitchen of those who craft executive compensation will subside to any great extent.

Accordingly, this paper will focus on the following factors, laws, and dynamics that may be thought to be of current interest in executive compensation:

- Reasonable Compensation
- Sarbanes-Oxley Act of 2002 ("SOX")
- Shareholder Activists
- I.R.C § 162(m)
- I.R.C. §§ 280G, 4999
- I.R.C. § 409A
- I.R.C. § 457A
- TARP

II. CURRENT ISSUES IN EXECUTIVE COMPENSATION

A. *Reasonable Compensation*

Often lost in the clutter and background chatter is the bedrock income tax issue of what constitutes reasonable compensation. As with many tax principles, the interests of individual taxpayers and the Internal Revenue Service ("IRS") often change depending upon the current structure of the federal income tax system. As a young practitioner, I saw tax advisors engaged in the effort of moving income into the wage compensation category. The burden of employment taxes was relatively small, and there was a significant difference in tax

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1. Perhaps it is no coincidence that Squeaky is up for parole while there are several different pieces of pending legislation, increased activism by RiskMetrics, and a federal "regulator" of compensation for certain financial enterprises that have received assistance from the U.S. government. *See* Ashley Hayes, *After 34 years, Lynette 'Squeaky' Fromme to be released*, CNN.COM, Aug. 5, 2009, *available at* http://www.cnn.com/2009/CRIME/08/05/squeaky.fromme.release/index.html?iref=allsearch.

rates between earned income (and wages constituting earned income) and "unearned" income (such as dividends) amounting to 50% and 70% maximum rates, respectively.[2]

Today, some practitioners and compensation recipients are attempting just the opposite. They are moving income from the wage category to the dividend/interest category, partially to avoid employment taxes in S corporation contexts. In some circumstances there may also be an effort to morph the income into capital gains, as these rates can be very low, or to obtain a deduction for the payor corporation.

Those whose practice involves primarily publicly traded companies often have little concern with the "reasonableness" per se of compensation. This is because it is thought that, in a public company, there are sufficient arguments as to why the interest of the company is adequately represented against the interest of the executive, so that income compensation payable to the executive is nearly by definition reasonable.

Recently, the IRS lost a significant case on reasonable compensation.[3] The defeat was resounding and the opinion of the Seventh Circuit was fairly scathing. No doubt, those who have an interest in the area will use this case as strong support for the amount of compensation that can be treated as "reasonable" in any particular situation.

In *Menard*, a controlling shareholder received a year-end bonus of 5% of net income, which totaled over $17,000,000.[4] As against a challenge by the IRS, the court first reviewed its discussion in *Exacto Spring Corp. v. Commissioner*[5] in which it concluded that the standards established by the IRS were without much utility. *Menard* further stated that multi-factor tests without concrete factors are not satisfactory, labeling such tests as "semantic vapors."[6] Among the other criticisms of the Tax Court's opinion, which the Seventh Circuit reversed, was that,

> [t]he Tax Court's opinion strangely remarks that because Mr. Menard owns the company he has all the incentive he needs to work hard, without the spur of a salary. In other words, a reasonable compensation for Mr. Menard might be zero. How

2. Peter Barnes, *Earned v. Unearned Income*, NEW REPUBLIC MAG., 1971, *available at* http://www.progress.org/barnes22.htm.

3. Menard, Inc. v. Comm'r, 560 F.3d 620 (7th Cir. 2009).

4. *Id.* at 624.

5. Exacto Spring Corp. v. Comm'r, 196 F.3d 833 (7th Cir. 1999).

6. *Menard*, 560 F.3d at 622-23.

> generous of the Tax Court nevertheless to allow the Menards to deduct $7.1 million from its 1998 income for salary for Menard![7]

A review of the facts of this case, including the respect paid to comparable compensation at publicly traded companies and the valuation of the "riskiness" of compensation, is instructive.

B. *SOX*

The Sarbanes-Oxley Act of 2002, known by the acronym SOX in Senate Report 107-205, aimed

> " . . . [t]o address the systemic and structural weaknesses affecting our capital markets which were revealed by repeated failures of audit effectiveness and corporate financial and broker-dealer responsibility in recent months and years . . . . The bill also requires steps to enhance the direct responsibility of senior corporate management for financial reporting and for the quality of financial disclosures made by public companies."[8]

SOX has several provisions that affect executive compensation. One such provision attempts to prevent corporate executives from dealing in company equity securities at a time when participants in a company 401(k) plan with investments in these securities are unable or are restricted in their ability to trade in them.[9] Another provision is a flat prohibition on the extension of personal credit by the issuer of equity securities to certain of its own senior officers, or the renewal of such an extension of personal credit.[10] A third provision is a requirement for disgorgement of profits made by an issuer's chief executive officer and principal financial officer in the event of certain restatements of financials.[11]

These provisions materialized as part of the fallout from Enron. During the relevant timeframe, there were reports that executives of failing companies or companies with false or misleading financials were urging employees to buy company stock in their 401(k) plans. There was more than one report of

7. *Id.* at 628.
8. S. REP. NO. 107-205, at 2 (2002).
9. Sarbanes-Oxley Act (SOX) of 2002 § 306, 15 U.S.C. § 7244.
10. *Id.* § 402.
11. *Id.* § 304.

executives receiving significant compensation based on the achievement of performance targets, the achievement of which turned out to be inaccurate and/or based on "cooked books." In several situations, senior officers and/or directors borrowed large amounts from a company to invest in company stock with the company's permission. When the stock declined, the individuals were unable to repay the loans. In addition, there was some thought that the extension of these loans was a way to move money from the company to the executives without adequate public disclosure.

1. Blackouts

SOX amended both securities laws and ERISA to provide for more protections for participants in 401(k) plans holding plan sponsor equity securities by requiring advance notice of such blackouts.[12] It also limited the ability of so-called "insiders" to trade during periods when participants in a 401(k) plan are unable to trade plan sponsor equity securities within the plan.[13] The provision provides that

> "it shall be unlawful for any director or executive officer of an issuer of any equity security . . . directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer . . . during any blackout period . . . if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer."[14]

The remedy for violation of this provision is disgorgement to the issuer. A blackout period is three or more consecutive business days during which at least 50% of the participants and beneficiaries under all issuer individual account plans are temporarily suspended by the issuer or by a fiduciary of such plan.[15]

There is a broader blackout period definition under ERISA with respect to other actions that may inhibit participant investment activities in a 401(k) plan, but those provisions do not otherwise interfere directly with executive compensation or executive sales and purchases of company equity securities.

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12. *Id.* § 306.
13. *Id.*
14. *Id.*
15. Sarbanes-Oxley Act (SOX) of 2002 § 306, 15 U.S.C. § 7244.

2. Loan Prohibitions

SOX § 402 provides that it is unlawful "for any issuer . . . directly or indirectly . . . to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer . . . of that issuer."[16] This statute essentially eliminated loans to directors and officers of public companies. While the SEC has yet to issue rules under this provision, an understanding developed with respect to which loans are personal and which are not. An understanding also developed with respect to company involvement in some practices as either constituting or not constituting indirect assistance in the making of loans. A memorandum signed by 25 law firms and dated October 15, 2002 essentially clarified these views.[17] The memorandum addresses the definition of "credit," the meaning of "personal loan," and the meaning of "arrange." It also sets out particular examples of arrangements that should not be treated as loans, such as travel and similar advances, certain personal use of company credit cards, and company cars.[18]

3. Disgorgement

An important sanction imposed by SOX is under § 304. It requires forfeiture of certain bonuses and profits if there is "an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws . . . ."[19] The significant interpretive issues presented by this provision include whose misconduct can raise a cause of action and who can bring a cause of action under § 304. Each of these issues has now been addressed, at least in part. The courts, by and large, determined that only the SEC can bring a cause of action under § 304(a).[20] Recently, the SEC weighed in on what misconduct is required, asserting that it may recover profits from a chief executive officer, even if that chief executive officer had not personally engaged in misconduct. Reportedly, the Securities and Exchange Commission ("SEC") took this position in a case in the U.S. District Court for the District of Arizona to order the former CEO

16. *Id.* § 402.

17. *See* Jeffrey M. Lipshaw, *Sarbanes-Oxley, Jurisprudence, Game Theory, Insurance and Kant: Toward a Moral Theory of Good Governance*, 50 WAYNE L. REV. 1083, 1089 n.18 (2004).

18. *See id.*

19. Sarbanes-Oxley Act (SOX) of 2002 § 304, 15 U.S.C. § 7243.

20. *See, e.g.*, Pedroli v. Bartek, 564 F. Supp. 2d 683 (E.D. Tex. 2008).

of CSK Auto Corporation to reimburse the company for more than $4,000,000.[21]

Perhaps a more important development to report is the continuing attention of the business community, regulatory agencies and Congress on "clawbacks" as a mechanism of corporate governance in reducing corporate/shareholder risk. Clawbacks have been the subject of discussions in Management's Compensation Discussion and Analysis and they have been "pushed" by shareholders rights groups, such as RiskMetrics (RMG). For example, RMG's 2009 policies state that "shareholder proposals on 'clawbacks' of incentive pay, which RMG previously did not support if a company had instituted a corresponding policy, may now receive support" if that policy does not meet the TARP standards that RMG describes as a "best practice."[22]

C. *Shareholder Activists*

Shareholder activists/rights groups are having an impact on executive compensation.

1. Withhold Votes on Directors

Perhaps the strongest tool employed by these groups is to threaten the reelection of nonemployee directors. RiskMetrics may recommend withholding votes for directors that approve new parachute tax gross-ups, which is but one example of what RiskMetrics considers to be "egregious compensation practices."[23]

2. Equity Compensation Plans

Under the rules for the two principal U.S. exchanges, the NYSE and NASDAQ, generally shareholders must approve equity compensation plans other than plans such as tax qualified 401(k) plans or Code § 423 employee stock purchase plans. In deciding whether to recommend approval in the case of RiskMetrics or to vote in favor of such a plan in the case of Fidelity, there are a variety of provisions that are either required or that may not be included in the programs. For example, in the case of so-called "free stock," such as restricted stock or restricted

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21. Maynard L. Jenkins, Exchange Act Release No. 3025, Litigation Release No. 21149A (July 23, 2009), *available at* 2009 WL 2341661.

22. RISKMETRICS GROUP, U.S. CORPORATE GOVERNANCE POLICY 2009 UPDATES 22 (2008), http://www.riskmetrics.com/sites/default/files/RMG2009PolicyUpdateUnitedStates.pdf.

23. *See Poor Pay Practices (U.S.)*, RISKMETRICS GROUP, http://www.riskmetrics.com/policy/2009us_poor_pay (last visited Mar. 17, 2010).

stock units that are settled in stock, Fidelity requires that if vesting is time based only, with limited exceptions, there be a minimum service period of three years and, in the case of performance based awards, a minimum service period of one year.

Option re-pricing has become more difficult as both exchanges prohibit re-pricing, unless the plan specifically provided for re-pricing and the plan was approved by stockholders or, where the plan did not specifically provide for re-pricing, the stockholders approved the re-pricing.

Most public companies now work with their proxy solicitors, as well as counsel, to determine what provisions are acceptable in equity compensation plans and what other compensation practices might affect votes on equity compensation plans or the re-election of directors.

"Say on pay" (i.e., the submission of executive pay to shareholders for approval) gained substantial momentum in the last year and is the subject of some bills introduced in Congress. Some companies even submitted their executive compensation programs to shareholders for "nonbinding" votes. For example, H&R Block included in its August 12, 2009 proxy as a separate item: "[t]he approval of an advisory proposal on the Company's executive pay-for-performance compensation policies and procedures."[24]

D. *Section 162(m)*[25]

Enacted as part of the Clinton tax bill in the summer of 1993[26] and incorporated into the Internal Revenue Code, § 162(m) quickly became a provision that only required "rearranging the deck chairs" as nearly all taxpayers were able to "work around it" without substantive impact by setting the performance goal hurdles low and the possible payouts high.[27]

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24. H&R Block, Inc., Proxy Statement (Form 14A), at 11 (Aug. 12, 2009).

25. I.R.C. § 162(m) (2006).

26. Omnibus Budget Reconciliation Act of 1993, Pub. L. No 103-66, sec. 13211, § 162(m), 107 Stat. 312, 470-471.

27. The "work around" is possible because, under the applicable regulations, discretion cannot be reserved to increase compensation if performance goals are achieved. However, it is permissible to reduce compensation even if performance goals are achieved—so-called "negative discretion." Therefore, by providing for a maximum payout in excess of what the Compensation Committee might otherwise think is appropriate, there is ample room to then reduce the compensation to a level thought appropriate by the Committee at the time of the payment, rather than having to make that determination a year earlier at the onset of, for example, an annual bonus period. In addition, if the performance goals are relatively modest (and requiring any profit is sufficient under the regulations to be an adequate performance goal), then achievement of

The intent of § 162(m) is to deny a deduction to a public company that pays a certain number of its most senior officers compensation in excess of $1,000,000 in any one year, with exceptions for "performance based compensation."[28] "Performance based compensation" generally means compensation that is paid only upon achievement of performance goals that are substantially uncertain of achievement at the time of establishment and that are established early in the performance period. Under the applicable regulations, stock options satisfy the "performance" requirement if they are granted at fair market value pursuant to a plan approved by stockholders where the plan contains a per person, per period limit.

Section 162(m) resurfaced as a significant issue in connection with the "option backdating" problems of the mid-2000s. Some companies, either innocently[29] or with scienter, granted stock options at less than fair market value for purposes of § 162(m). The consequence of granting options at less than fair market value was that any income earned by the holder of the option was thereupon not protected under § 162(m) and subject to the $1,000,000 "cap" on deductible compensation payable to certain officers of publicly traded companies. That, in and of itself, would perhaps not have been so bad, but the non-availability of the deduction aggravated what was already an accounting issue created by the "discount" on the exercise price. That is, the books of the issuer of the options would anticipate the tax benefit of a deduction for any gain. Therefore, the company's books were "wrong." The other aggravating accounting factor was that under the accounting rules in effect throughout the early 2000s, namely APB 25,[30] options granted at fair market value did not result in a charge to current income. By comparison, if there were a discounted option, there would be a current charge. Having options granted at a discount therefore

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the goals could virtually be assured. The net result is that, while the goals and maximum payouts are established on day one, most Compensation Committees have significant flexibility at the end of the performance period to actually determine the amount of bonus that would be appropriate.

28. I.R.C. § 162(m)(4)(C).

29. Reported "innocent" problems occurred when a compensation committee would grant options on day one in a block and delegate to the chief executive officer the right to distribute out these options to lower level employees, which the chief executive officer did over the next several days. This arguably resulted in the option grant date being the date that the chief executive officer identified the employees by name. If the stock price had increased since the date of the compensation committee action, the options would not have been granted at then market value and thus, not eligible to be treated as performance based compensation under § 162(m). *See, e.g.*, Chief Counsel Attorney Memorandum (July 17, 2009), *available at* 2009 WL 2138881.

30. Accounting Principles Bd., Op. 25 (1972).

resulted in incorrect accounting and incorrect financials for a second reason, namely that the "discounted portion" of the option was not properly reflected in the company's books and records. This problem has not yet worked its way through the system, as there are still cases pending that involve the allegedly improper financials attributable to this option "backdating" circumstance.

The issues with respect to option backdating may well have ended with two changes in the way options are now treated by publicly traded companies. First, requirements mandate that publicly traded companies follow accounting rule FAS 123R,[31] which, unlike APB 25, requires a charge to current earnings for any equity grant, including options. As a result, even the grant of an option at fair market value would require a current income charge. Second, public company stockholders now have to approve of all stock option plans and the plans may not provide for "discount" options unless specifically approved by the shareholders. Finally, the grantee must report the grant of options for "insiders" within two business days on a Form 4. This lessens the possibility of a grant date pricing variance.

A second § 162(m) issue of relatively current interest resulted from the change by the SEC in its requirements for disclosure in publicly traded companies' proxy materials of the compensation of senior executives. When § 162(m) was enacted, the SEC required disclosure[32] on essentially the chief executive officer (and any person who had served as chief executive officer during the relevant year) and the next four highly compensated executive officers (and any other two executive officers who would have been included, but had departed during the relevant year or lost their status as executive officers during that year). Therefore, the group of concern for § 162(m) was the chief executive officer and the next most highly compensated four executive officers who were "in service" on the last day of the relevant year.[33]

The SEC proxy disclosure rules now require compensation disclosures for the chief executive officer, the principal financial

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31. Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd. 2004) (changing to FASB ASC Topic 718 under the new "codification" rules). *See also* Press Release, Frederic W. Cook & Co., Inc., FASB Launches New Accounting Standards Codification (Sept. 28, 2009), *available at* http://www.fwcook.com/alert_letters/09-28-09_Originally9-03-09_FASB-Launches-New-Accounting-Standards-Codification.pdf.

32. Actually, the disclosure was changed shortly after enactment of § 162(m). One of the problems of § 162(m) is that it keys off rules that can be changed by the SEC from time to time.

33. While the statute does not precisely require this rule, it was adopted in the regulations perhaps to conform the statutory requirement with respect to the chief executive officer and the other four executive officers.

officer and the next three most highly compensated officers. Following the change to this rule, the IRS issued Notice 2007-49,[34] squarely holding that the principal financial officer was no longer subject to § 162(m), which is a curious, although perhaps proper, result under the statute and the regulations.

The final current concern under § 162(m) is that, under the TARP provisions, some compensation falls under the limitations of § 162(m), but with a "hard cap" of $500,000 on the deduction and denial of the deduction without regard to whether the compensation is performance based.[35]

E. *Sections 280G[36] and 4999[37]*

Enacted in 1984, partially as a reaction to large severance packages being paid to executives of companies that were "taken over," the so-called parachute tax provisions imposed sanctions on both the recipient of payments and the payor if there are "excess parachute payments." The sanctions include an additive 20% excise tax imposed on the recipient and non-deductibility by the payor.[38] The "penalties" are substantial and increase markedly the "cost" of compensation.

Not long after the enactment of Code § 280G, parachute tax gross-ups became *de rigueur.* Most surveys indicate that, until recently, the large majority of publicly traded companies provided parachute tax gross-ups to their most senior executives. In economic terms, adding the parachute tax gross-up can have a significant effect on the "cost" to the company, as not only are some of the basic payments non-deductible, but the entire gross-up is non-deductible.

The trend on parachute tax gross-ups is that they are becoming less common for several reasons. First, there has been a sharper focus among both the public arena and shareholder activists on parachute payments and their costs. This focus came about, in part, because of the requirement to disclose for the top officers the affect of parachute tax gross-ups through providing to shareholders quantification and qualification of the payments to be made upon termination of employment of executives, including upon a change of control. In addition, as noted earlier, providing parachute tax gross-ups may provoke the withholding of votes for the election of non-employee directors.

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34. I.R.S. Notice 2007-49, 2007-1 C.B. 1429.
35. I.R.C. § 162(m)(5)(A)(i) (2006).
36. I.R.C. § 280G (2006).
37. I.R.C. § 4999 (2006).
38. *Id.* § 4999(a).

It seems that the parachute tax provisions do not have much impact in the context of non-publicly traded companies. As with shareholder approval, companies can usually eliminate the adverse tax consequences. There are techniques for obtaining an approval that suggest that it would be the rare case that parachute taxes would be a real "problem" in changes of control of non-publicly traded companies.

F. *Section 409A*

Tucked into tax legislation styled "The American Jobs Creation Act of 2004" was a provision that added Code § 409A.[39] The experience is that no change to the Code produced more work for executive compensation practitioners in the last several decades than Code § 409A. The provision is likely in reaction to some of the perceived "abuses" in the Enron situation (the gift that keeps on giving) and was generally effective for amounts deferred after December 31, 2004. Between the date of enactment in October 2004 and December 31, 2008, the IRS published a number of pieces of guidance and this guidance generally deferred most of the "pain" associated with these rules until tax years beginning after 2008.

Code § 409A generally provides that so-called non-qualified deferred compensation can be payable only on one of six enumerated events, can rarely be accelerated and can be the subject of a subsequent deferral provision only in very circumscribed situations. Code § 409A also has "form" requirements much akin to those applicable to so-called tax qualified plans under § 401(a) and other Code provisions.

Generally, non-qualified deferred compensation subject to § 409A is generally compensation with respect to which services begin or are provided in one year and payment, *in any imaginable circumstance*, can be made later than March 15 of the year following "vesting." Failure to comply with a myriad of § 409A rules will result in a 20% additive income tax, possibly treated as if due earlier so that the tax is subject to "retroactive"

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39. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418, 1634. The mere title of this legislation and the new Code provision should have portended for the experienced tax practitioner significant angst, as the use of the word "American" and a code section employing a capital letter has been problematic in the past, at least to compensation benefits practitioners. *See, e.g.*, I.R.C. § 280G (2006) (one of the parachute tax provisions); I.R.C. § 4979A (2006) (related to allocations of securities in ESOPs); I.R.C § 4980B (2006) (COBRA); I.R.C. § 4980F (2006) (notice with respect to reductions of certain benefit accruals); I.R.C. § 4980G (2006) (relating to health savings account contributions).

interest as well.[40] The statute and regulations promulgated thereunder are in many respects non-intuitive.

The following two examples show the complexity of § 409A.[41] First, suppose we have twin employees. The employer promises the first employee that the employer will pay $10,000 in three years if the employee works for three years. The employer promises the second employee $10,000 payable in three years whether the employee works or not. The employer and employee are free to, at any time, accelerate the payment of the amounts due to the first employee; however, generally speaking, once the first day of services are performed, "pushing back" the payment date is difficult. Contrarily, in the case of the second employee, even though the compensation has been completely earned, accelerating the payment date is generally forbidden and the same "limited" pushing back of the payment date is applicable. Why the employer treats the employee who completely performed all the services and earned the compensation less well than the employee who has not yet earned the compensation is a product of what the writer believes is flawed "theology" behind the regulations promulgated under § 409A.

For a second example, imagine an employer who promises the employee a payment in year one if the employee provides some services in year one and the employee could be vested in year one, but the payment might be made in year one or in year two. If the agreement between the employer and the employee provides that the amount will be paid in year one and it is paid in year one or by March 15 of year two, then it is exempt from § 409A. If the employer and employee agree that it could be paid in year one and it is paid after March 15 in year two, then a violation of § 409A occurs. If the employer and employee agree that the amount can be paid in year one or year two, but, in any event, not later than March 15 of year two, then, as long as the amount is paid before March 15 the year two, it is exempt from § 409A. However, if it is paid later than March 15 of year two, there is a violation of § 409A. Finally, if the employer and the employee agree to pay the amount on March 15 in year two, then the amount can be paid at any time in year one or year two and either be exempt from § 409A or, if paid after March 15 but by the end of year two, be compliant with § 409A. This brings to mind the refrain from the Joker, "riddle me this."[42]

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40. I.R.C. § 409A(a)(1)(B)(i) (Supp. 2009).

41. *See, e.g.*, I.R.C. § 409A(a)(2)(A) (Supp. 2009).

42. The Riddler (Character)—Quotes, http://www.imdb.com/character/ch0000179/quotes (last visited Apr. 7, 2010).

As noted earlier, § 409A has a myriad of requirements. Generally, similar to the rules with respect to tax qualified plans, they fall into two categories, namely compliance in both form and operation. As noted, there was a general relaxation of the rules until the end of 2008, with the "form" requirements only being applicable and generally effective in 2009 and thereafter. Operationally, subject to some good faith compliance and other relaxed standards, nonqualified deferred compensation arrangements had to comply in operation with the § 409A rules, even before 2009.

It does not take a practitioner considering § 409A long to ask the question of what happens if an arrangement subject to § 409A has a "mistake." In the case of certain operational failures, an IRS notice provides a mechanism for correcting some failures in the year of the failure, some in the year after the failure and some possibly as late as two years after the failure, subject to a variety of conditions and limitations, much like the EPCRS procedure.[43] On the other hand, with a limited and nuanced exception, if one has a nonqualified deferred compensation plan subject to § 409A that has a single small mistake in the form, there is no way to correct it and the arrangement is forever tainted.[44]

While detailed analysis of § 409A is beyond the scope of this Article, the following are some of the principles to consider in dealing with arrangements that might be or are subject to Code § 409A:

1) The arrangement must be reduced to writing.
2) If subject to Code § 409A, the arrangement can provide for payment only upon a specified date, an unforeseeable financial emergency, a change in control (as defined), disability (as defined), a separation from service (generally defined as termination of employment in the case of employees), or death.
3) The time and form of payment of nonqualified deferred compensation must generally be fixed before the year in which services are first rendered that generate the payment. For example, if services in 2010 are to be the subject of deferred compensation remuneration,

43. *See* Rev. Proc. 08-50, 2008-35 I.R.B. 464.

44. Since this paper was presented at the HBTLJ Annual Symposium on October 15, 2010, the IRS has provided a limited forum correction. Rev. Proc. 2010-6, 2010-1 I.R.B. 193.

generally the time and form of payment must be fixed by the end of 2009.[45]

4)All compensation of a similar type receives treatment generally as if it is made under a single plan, so that if one has two arrangements and one is defective, the compensation under both arrangements is tainted. In this regard, there is an attached list of the "buckets"[46] into which the regulations apportion different types of nonqualified deferred compensation.

5)There are substantial reporting requirements, including an obligation to advise the IRS periodically when nonqualified deferred compensation exists, even if it is not currently taxable and complies with § 409A.

6)Unlike §§ 280G and 4999, which impose sanctions with respect to excess parachute payments on both the employer and the employee, and § 162(m), which imposes sanctions for noncompliance only on the employer, Code § 409A imposes sanctions only on the employee/service provider. There are circumstances in which the employer/service recipient can take actions that would cause noncompliance of § 409A and it is not clear whether the employee/service recipient would have any remedy by reason of the incurrence of the increased tax attributable to the employer/service recipient's actions.

7)Certain arrangements are exempt from § 409A, such as stock options and transfers of property subject to § 83 (including interest in secular trusts). In order for options to be exempt, they must be granted at market and must be with respect to stock of the employer or a parent or other upstream affiliate of the employer.

8)The rules with respect to deferred compensation in partnership circumstances are not developed and, for the present, the rules applicable to corporations are to be applied by analogy.

9)The IRS does not have any procedure for "form approval," nor can one obtain rulings. The IRS also has no analog to the EPCRS procedure other than the Notice mentioned above.

10)As noted, the rules under § 409A are, in many respects, unintuitive and can be incredibly complex in application. Anything beyond the most simplistic of arrangements

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45. There are some exceptions for performance based compensation and compensation where the right to receive the compensation arises during the year.

46. *See infra* Appendix II.

which provide for payment of compensation more than a short time after the services are performed that give rise, in whole or in part, to the compensation requires careful examination. Many fail to appreciate that these rules apply across the board, as opposed to just executives, officers, or highly compensation employees. For example, secretaries and administrative personnel who receive severance pay might find that pay subject to § 409A.

11)Attached is a short memorandum discussing some of the major points that a practitioner might review in connection with § 409A, as well as a list of some of the "exemptions" from Code § 409A.[47]

G. *Section 457A*

Section 457A went into effect on January 3, 2008.[48] This new section addressed income timing issues associated with "tax indifferent" employers and other service recipients.[49] Suitably placed following § 457, which significantly limits deferred compensation payable by so-called "tax exempts," the reach of § 457A is broad in its application and its operation in practice is very uncertain. While all the complexities of § 457A are beyond the scope of this Article, from a high level § 457A requires income inclusion by a service provider when the service provider has a "vested" right to the compensation. If the amount of compensation is uncertain at the time of "vesting," then when the amount of compensation becomes known, not only is it includible in income, but it is also subject to an additional 20% tax plus an enhanced interest charge on the deemed underpayment of taxes as of the vesting date.[50]

The provision, in part, aims at "offshore" arrangements maintained by a "nonqualified entity." An entity is "nonqualified" if it is any foreign corporation, unless a substantial level of its income is effectively connected with the conduct of a U.S. trade or business or is subject to a comprehensive foreign income tax.[51] Partnerships are also nonqualified entities unless substantial levels of the partnership's income are allocated to persons other than U.S. tax

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47. *See infra* Appendix III.

48. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, sec. 801, § 457A, 122 Stat. 3765, 3929.

49. *Id.*

50. *Id.* § 457A(c)(1).

51. *Id.* § 457A(b)(1).

exempt organizations and foreign persons where the income is subject to a comprehensive income tax.[52]

The provision is effective for services performed after December 31, 2008. There is a transition period that ended June 30, 2008, within which compensation that would otherwise be subject to the rules because it was "accrued" as of December 31, 2008, but not vested, could be voluntarily vested.[53] Moreover, deferrals in effect as of December 31, 2008 must be includible in income in the last taxable year beginning before 2018, or the year in which the amounts are no longer subject to substantial risk of forfeiture if later.[54]

A key provision is that a substantial risk of forfeiture is keyed only to the performance of substantial future services; traditional performance conditions, such as those imposed to comply with § 162(m), do not count in determining whether there is a substantial risk of forfeiture.[55] In addition, to avoid § 457A additional taxes, the income must be recognized no later than 12 months after the end of the employer's tax year in which vesting occurs.[56]

Substantial complexity exists because of the need to determine, on an entity-by-entity and year-by-year basis, whether the "payor" of the compensation is a nonqualified entity. This involves difficult determinations that vary depending upon whether the entity is a corporation or a "look through," the jurisdictions in which the entity is subject to taxation and whether the income has flowed through other entities before it gets to the payor. IRS Notice 2009-8 provides substantial guidance.[57]

Curiously, there is no legislative history, nor is there an official explanation of the intent of § 457A, although there is history for earlier proposed legislation that included substantially similar language to § 457A.

H. *TARP*

Under the Troubled Assets Relief Program (TARP), there are several restrictions relating to executive compensation. The TARP program was part of the American Recovery and

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52. *Id.* § 457A(b)(2).

53. *Id.* § 457(a)(d)(1), (3).

54. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, sec. 801, § 457A(d)(2), 122 Stat. 3765, 3931.

55. *Id.* § 457A(d)(1)(A).

56. *Id.* § 457A(d)(3)(B).

57. I.R.S. Notice 2009-8, 2009-4 I.R.B. 347.

Reinvestment Act of 2009, which, in many ways, expanded the reach of some executive compensation provisions of the Emergency Economic Stabilization Act of 2008. For those affected by TARP, the restrictions on the payment and provision on executive compensation can be significant. Even for those who are not directly impacted by TARP, several aspects hold interest. These include the possibility of follow-on legislation that might expand the scope of TARP restrictions on executive compensation and the announcement by the SEC of additional disclosure requirements in connection with executive compensation for those companies that are subject to public filing requirements.

The executive compensation restrictions apply to those that received TARP funds with gradually increasing levels of restriction as the amount of economic assistance increases. For the seven companies[58] that are reportedly subject to the most restricted provisions, the stakes are substantial. Indeed, by mid-August 2009, each of these companies had to submit its executive compensation programs to a "compensation czar" for approval or disapproval. The decision with respect to these compensation arrangements is expected within 60 days of the submission date.

While the statute has lots of complexity, and there are many unanswered questions, the following is a summary of the salient provisions.

There is no direct limitation on the amount of salary that can be paid. There is a limitation on the amount of incentive compensation equal to no more than one-third of the total annual compensation payable to an individual, suggesting that if the salary is $1,000,000, no more than $500,000 of long-term incentives can be provided.[59] The only permissible long-term incentive is restricted stock with very strict vesting provisions, principally that the stock cannot vest during the period that the TARP recipient is subject to TARP based restrictions.[60]

No severance or similar payments can be provided.[61] Bonuses, retention awards or incentive compensation for the most senior officers must be the subject of clawbacks.[62] The

58. They are American International Group, Citigroup, Bank of America, General Motors, Chrysler, Chrysler Financial, and GMAC. David Cho, Zachary A. Goldfarb & Tomoeh Murakami Tse, *U.S. Targets Excessive Pay for Top Executives*, WASH. POST, June 11, 2009, at A1.

59. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 7001, § 111(b)(3)(D)(i)(II), 125 Stat. 115, 517-518.

60. *Id.* § 111(b)(3)(D)(i)(I).

61. *See id.* § 111(a)(2), (b)(3)(C).

62. *See id.* § 111(f).

compensation packages of the senior executives must go to shareholders for an up or down vote, although the vote is nonbinding.[63] There is a restriction on "luxury expenditures,"[64] and there are caps on tax deductions of $500,000 per executive officer in any year without regard to whether the compensation might be considered "performance based" within the meaning of § 162(m).[65] There are limits on parachute tax gross-ups.[66]

While the TARP restrictions do not apply literally to a new hire, as the compensation czar will have to approve all compensation practices of a TARP recipient and the compensation practices with respect to a senior officer at least by the third year of employment, providing compensation to a new hire that is inconsistent with the spirit of TARP may subject the TARP recipient to sanctions or disapproval by the compensation czar.[67]

Finally, TARP recipients must take steps to avoid "unnecessary and excessive risks," including risk with respect to executive compensation.[68] The idea is to assess and design executive compensation programs to prevent "excessive risk," whatever that may be.

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63. *Id.* § 111(e).

64. *Id.* § 111(d).

65. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, sec. 302(a), § 162, 122 Stat. 3765, 3802; I.R.C. § 162(m)(5) (2006).

66. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 7001, § 111(b)(3)(B), 125 Stat. 115, 517; Press Release, U.S. Dep't of the Treasury, Interim Final Rule on TARP Standards for Compensation and Corporate Governance (June 10, 2009), *available at* http://www.ustreas.gov/press/releases/tg165.htm.

67. *See generally* DELOITTE, THE PAY CZAR'S RULING ON COMPENSATION PRACTICES FOR COMPANIES THAT RECEIVED "EXEPTIONAL ASSISTANCE" (2009), http://www.deloitte.com/assets/Dcom-UnitedStates/Local Assets/Documents/us_consulting_PayCzarRulingonComp_121109.pdf (explaining the position of the compensation czar in relationship to compensation practices).

68. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, sec. 7001, § 111(b)(3)(A), 125 Stat. 115, 517.

APPENDIX I: SECTION 409A FINAL REGULATIONS AND WHY YOU WILL COME TO KNOW YOUR BENEFITS COUNSEL

On April 10, 2007, the IRS issued long awaited § 409A final regulations, consisting of a total of 397 double spaced pages.[69] These regulations do not cover all of the matters subject to § 409A, such as the details of imposition of sanctions. Although they are completely rewritten in many respects, the regulations generally track the principles of the proposed regulations (September 2005) and IRS notice guidance previously issued, but they include some additional and welcome relief as well as some continued adherence to positions that present challenges to taxpayers and counsel.

Where It Began

It is accepted lore that ERISA (enacted in 1974) was the product of the Studebaker demise, which left pensioners adrift without any funding for promised retirement income. While the problems of the U.S. pension system had been known for a long time, Studebaker served as a catalyst for "reform" in no small measure because the politics were right. However, some of the most significant problems of funding were not adequately addressed, namely the multiemployer plans like Central States Teamsters; it was only later, in 1980, that significant additional legislation addressed at least in part this issue.

Later, Enron and the bursting of the dotcom bubble came about. Many employees were left high and dry while executives at some companies were able to "bail" and avoid some of the problems of an employer's insolvency or other financial difficulties. Among those employers was Enron, and Enron had perceived ties to the President, so the "politics" were right for "reform."

Reasons For Change

What needed to be "reformed"? It was widely reported that on the eve of Enron's demise some executives were able to access and be paid by Enron previously deferred and "vested" nonqualified deferred compensation while other executives received either large bonuses or severance payments that were not previously "vested." The legislature responded to this perception of inequitable treatment, whereby executives got paid and employees not only lost their jobs but also suffered losses in their 401(k) accounts as many Enron employees were heavily

69. *See, e.g.*, Posting of Broc Romanek & Dave Lynn to The CorporateCounsel.net Blog, http://www.thecorporatecounsel.net/blog/archive/001370.html (Apr. 11, 2007, 06:46).

invested in Enron stock, with § 409A. (SOX, enacted in 2002, addressed in part the issues associated with employer stock in 401(k) plans.)

The "Medicine"

So, what was the reform reflected in § 409A? There are three separate "thrusts" of the statute:

- Limiting elections, including changes to previously established payment dates, by service providers (including self-employed individuals and entities as well as employees) on when and how to receive "nonqualified deferred compensation" ("NDC")
- Limiting the "triggers" for payment of NDC
- Limiting funding, including implicit funding, of NDC

Reasons For Compliance

So why "comply" with § 409A's rules? I think it is useful to contrast § 409A with two other tax statutes that affect compensation: §§ 280G/4999 and 162(m).

Under §§ 280G/4999, enacted in 1984 (everyone says "taxed under § 280G," but the "tax" is imposed under § 4999 and § 280G just disallows a deduction), if there is a change in control of a corporation (a "tax" corporation), then amounts paid in the nature of compensation to so-called "disqualified individuals" (read here "highly-paid") that are accelerated in time of payment or are "new" payments can be subjected to a 20% excise tax imposed on the recipient of the compensation, and a compensation deduction to the payor can be disallowed.[70] This effectively increases the "cost" of delivering the compensation. While the statute applies to all corporations, by and large only publicly traded companies and their highly-paid employees (as well as directors and some independent contractors providing services to the companies) cannot avoid the dual sanctions. Perversely, by setting the limit on compensation that can escape the sanctions at three times historical average compensation, the statute encouraged companies to increase their so-called parachute payments to at least three times average compensation, and, as if that were not enough, provide a tax gross-up to the compensation recipient. It is the subject of another story, but these gross-ups are under attack, as are severance payments generally, by "shareholders' rights" groups and organizations. So, in sum, §§ 280G/4999 is an equal opportunity offender: sanctions apply to both the employer and the employee.

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70. I.R.C. §§ 280G(a), (b)(2) (2006); I.R.C. § 4999(a) (2006).

Section 162(m), which became effective in 1993 (and was passed by Congress on the basis of Gore's tiebreaking vote in the Senate), provides that if nonperformance-based compensation provided to more or less the "top 5" officers of a publicly traded company exceeds $1 million then such excess is not deductible.[71] Compensation is performance-based if it is subject to predetermined objective goals that are substantially uncertain of achievement at establishment, approved by shareholders, adopted by an independent compensation committee and paid only after the committee certifies achievement of such goals.[72] The sanction for violating regulations on performance-based compensation only applies to the employer, so the employee can be more or less ambivalent. The sanction is avoidable without much effort by "setting the performance standards low" and the "possible payouts high" with the compensation committee, then using "negative discretion" to decide how much to pay the executive. If all else fails, if the compensation is deferred until the executive is affected by "loss of status" as a top 5 person, then § 162(m) is avoided.[73] Such deferrals could be subject to § 409A (and likely will be), but the final regulations actually encourage this type of § 162(m) avoidance. Note that there can be a "mismatch" between the definition in § 162(m) of "top 5" and the SEC's "proxy 5" definition, as the § 162(m) definition came from a version of the SEC rules that was changed before § 162(m) became effective.[74] With the recent change to the SEC rules on who is to be in the "proxy 5," the Treasury has been seeking a way to conform the § 162(m) definition with the new SEC rules. However, the Treasury has a statute to deal with the fact that, on its face, the definitions would not permit full congruence. Nevertheless, you can expect proposed changes as to who is covered by § 162(m) in the not too distant future.

Enter § 409A, which imposes penalties only upon the recipient of the compensation. The penalty is a 20% add-on tax (many are calling this an excise tax, but it is not) with the possibility that the tax is imposed retroactively, which then adds interest to the sanction.[75] Moreover, if a particular type of

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71. I.R.C. § 162(m)(1),(3) (2006).

72. *Id.* § 162(m)(4)(C).

73. *Id.* § 162(m)(3).

74. *Compare id.* (detailing the § 162(m) position) *with Treasury Department and SEC Announce New Executive Compensation Initiatives*, MCDERMOTT NEWSLETTERS (McDermott Will & Emery, Chicago, Ill.), June 12, 2009, *available at* http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/0f1fff5a-602d-48f0-8d21-20fcd8b4a894.cfm (detailing the SEC position).

75. I.R.C. § 409A(a)(1)(B) (Supp. 2009).

arrangement does not comply with § 409A, then this deems all arrangements of the same type between the service recipient and the service provider noncompliant.[76] There can be as many as nine different types of arrangements recognized under § 409A. Section 409A applies to employees, directors, and independent contractors. Section 409A applies to so-called "service providers" generally, so coverage extends to those receiving compensation from public and private companies, partnerships and joint ventures, sole proprietorships, tax exempts and government entities.

The "reform" contained in § 409A is, in many respects, nonintuitive and, under the approach taken in both the proposed and final regulations, does not prevent what may be perceived as the worst of the Enron compensation abuses. For example, if an employer decides to pay an executive a large sum and makes the payment immediately, no problems arise under § 409A, even if this transaction is on the eve of financial difficulties (although subsequent changes to US bankruptcy laws appear to have "plugged" this loophole, perhaps too well, as it is now very difficult to establish retention/severance pay programs for executives of the bankrupt or about to be bankrupt companies).

The following is an example of the idiosyncrasies of § 409A. An employer promises an executive in 2007 to pay the executive in 2011 a large sum, but only if the executive works until 2011. Then, the employer changes its mind, waives the continuing service condition and "vest" and pays the sum earlier to the employee. Section 409A does not apply. Compare this result to the situation where the employer promises in 2007 to pay the executive in 2011 in all events (read "vested") a large sum. Under § 409A, if the employer accelerates the payment date of this large sum to any date prior to 2011, § 409A sanctions may apply. Why does this occur? Primarily, this occurs because § 409A applies only to NDC, and the Treasury has adopted a definition of NDC that treats the former promise as not providing such compensation.

So, if Enron were to repeat, Enron could pay its executives any amount it had not promised to pay, as well as many amounts that it promised to pay but that were "unvested," without running afoul of § 409A. Only amounts that were or are to be paid after "vesting" are subject to § 409A sanctions. To emphasize, amounts earned and vested for prior service can't be paid, but unearned prior awards and new awards can be paid!

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76. *Id.*

Key Compliance Issues/Concerns

Now that we have some background, including the fact that § 409A has some "wrinkles" that can be difficult to anticipate and/or understand, let's examine in more detail what § 409A is about and the concerns for practitioners.

Section 409A requires compliance in both "form" and "operation" in order to avoid the sanctions. To date, not much literature exists about "form" requirements, but I think that this prong of compliance is more difficult than the operation prong. Why? Because it requires that all NDC be established and/or paid pursuant to a written plan. If it is not in writing, the NDC per se cannot comply with § 409A. The requirements for the written plan are such that the plan must anticipate every possible time and form of payment. While some changes to "form" are permissible "post establishment," at the moment, absent some particularized circumstances, trying to change time and form of payment is not a useful effort.

Some of you may be familiar with the form and operation requirements applicable to tax qualified plans such as the firm's 401(k) plan. The firm 401(k) rules are so complex (and have been since the memory of man runneth not to the contrary) that one gets a letter from the IRS that essentially says the form of plan complies even when it has some technical or other defect. There will be no such "determination letter" program for NDC, so we are left to our own efforts. This may encourage one or more very conservative positions, applications for individual private letter rulings on the form of a particular plan and/or § 409A tax gross-ups (yes, they are already popping up).

The Form Requirement

Under presently applicable transition rules, the form requirement need not have been complied with until the end of 2007 (not a long time when you think of the number of arrangements that have to be amended after one has an opportunity to digest the regulations). Some of the arrangements that will require review for § 409A form compliance include:

- Employment agreements
- Severance plans/agreements
- Annual incentive programs
- Long-term incentive programs
- Excess 401k plans
- Excess pension plans
- Supplemental pension plans
- Unfunded notional individual account plans
- Rabbi trusts

- Secular trusts (usually exempt)
- "Omnibus" executive compensation plans
- Restricted stock (usually exempt)
- Restricted stock units/phantom stock
- Stock options
- SARs
- Nonemployee director programs
- Partnership unit options
- Partnership unit appreciation rights
- Split dollar insurance
- Elective deferred compensation
- Nonelective deferred compensation
- Post termination medical
- Post termination life insurance
- Tax gross-ups
- Indemnities
- Payment of expense programs
- Attorneys' fees provisions
- "Highest price" equity provisions
- Acceleration of payment upon change in control
- Disability programs
- Vacation pay programs
- Provision of office and/or support staff
- Outplacement
- Financial counseling
- Tax return preparation
- Tax equalization arrangements
- Moving expense reimbursements
- Club dues
- Use of employer aircraft
- Release requirements
- Noncompetition agreements
- Home security
- Foreign plans

In addition, falling in the "things aren't easy" category is the position of the government that by and large "failsafe" or "savings" clauses are not sufficient. As a result, a position will have to be taken with respect to each and every element of compensation and payment triggers prior to the "deferral." One favorable element of the final regulations is that, if an arrangement has been "wound up" before the end of 2007, it need not be amended to comply with the form requirements, although

just terminating such arrangements is difficult without triggering an operational failure.

Operational Compliance

Section 409A has been effective since January 1, 2005, and compliance in operation has been a requirement from and after that date (in fact some actions in late 2004 were subject to § 409A). In the § 409A proposed regulations (September 2005), there is a general "reasonable good faith" standard for operational compliance until the end of 2007. Generally, one can amend a program any time this year[77] to change the time and form of payments of NDC that otherwise would be made after 2007; this is, more or less, a "wildcard" to change to any NDC.

The operational standards (ignoring the "funding" rules which, by and large, are not issues for US plans) are, as noted, in two areas: elections to defer and time receipt of compensation (and thus year of taxation) and payment triggers.

The rules on deferral elections are generally:

- Elections by service providers to both defer NDC and elect the time and form of payout must generally occur in the calendar year prior to the year in which any services are performed that generate the right to the compensation.[78]
- Elections with respect to "performance-based" compensation can occur not later than six months before the end of the performance period, if the performance period is at least one year in length.[79] "Performance-based" is a much less strict requirement than the requirements found in § 162(m) and can be based on the subjective assessment of the service provider's efforts for the period.[80]
- Changes to elections as to timing and form of payouts must occur in advance (generally one year) before the original payout date.[81] In some cases, the plan must require any change to defer the payment for at least five years from the original payout date.[82]
- No acceleration of payments is permissible, except in very limited circumstances. Examples of such circumstances include plan terminations in

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77. T.D. 9321, 2007-1 C.B. 1123 ("[T]his year" refers to 2007).
78. Treas. Reg. § 1.409A-2(a)(3) (2007).
79. *Id.* §§ 1.409A-1(e)(1), 1.409A-2(a)(8).
80. *Id.* § 1.409A-1(e)(2).
81. *Id.* § 1.409A-2(b)(1)(i).
82. *Id.* § 1.409A-2(b)(1)(ii).

transactions, payouts to avoid government service conflict of interest rules, and the like.[83]

Once there is NDC, significant limitations are the "triggers" that can result in payment. There are only six:

- Death
- Disability as defined in § 409A (a fairly restrictive definition)
- Unforeseeable emergency (forget about this one for any executive)
- Fixed date
- Change in control as defined in § 409A final regulations
- Separation from service/termination of employment[84]

The details of the implementation of these permissible triggers are numerous. A couple of the more important aspects include that the § 409A change in control definition is surprisingly liberal.[85] There can be multiple fixed payment dates, and for top employees of a publicly traded company, payments by reason of termination of employment can only be made after the lapse of six months following termination.[86]

Illustrative Issues for Particular Types of Compensation

- Deferrals generally: If it is paid after March 15 of the year following "vesting," the item is subject to § 409A. Amounts paid by the March 15 date are exempt as "short-term deferrals."[87]
- Options: Must be granted with fair market value strike price and with respect to stock of the service recipient or a member of its controlled group. Only common stock can be the subject of the grant, and such stock can have only limited preference rights, namely upon liquidation.[88] Modifications made post-grant can be problematic.
- SARs: Same as options.
- Partnership options and SARs: Apply rules of stock options and SARs by analogy.
- Restricted stock: Generally exempt from § 409A.

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83. *Id.* § 1.409A-3(j); *see also id.* § 1.409A-2(b)(5).
84. Treas. Reg. § 1.409A-3(a) (2007).
85. *See id.* § 1.409A-3(i)(5).
86. *Id.* §§ 1.409A-1(i), 1.409A-3(i)(2)(i).
87. *See id.* § 1.409A-1(b)(4).
88. *Id.* § 1.409A-1(b)(5)(iii)(A).

- •Restricted stock units: Subject to § 409A unless paid by March 15 of year following vesting.
- •Annual bonus: If purely discretionary, not subject to § 409A. If formulaic, subject to § 409A; if not, paid by March 15 after end of measurement year.
- •Employment/severance agreements: Are viewable as vested if for good reason or because of the window period trigger, subjecting all payments to § 409A, even those actually made upon death. These agreements may cover as few as one type of payment or as many as 30. If the payments are "bundled" (employee will receive all the welfare plan benefits he would have received had employment continued), consider identifying each benefit/payment and unbundling.
- •Change in control: Most agreements do not comply if they have such a payment trigger. Compliance with § 409A is not difficult in many cases. A typical agreement that provides for elective termination following a change in control, such as for good reason or any reason during a window period, will not be treated as a change in control trigger, but will be subject to the termination of employment rules instead.
- •Vesting: Section 409A does not affect the right or grant of accelerated vesting unless that vesting triggers early payment as well.
- •IPOs: Can be an eligible trigger event if properly structured.
- •Equity valuation: Final regulations liberalize this, especially for start-ups and private companies, but care is still the watchword for equity rights that require fair market value determinations.
- •Foreign plans: Generally have been excluded from the rules, but issues arise for U.S. taxpayers participating in foreign plans and non-U.S. citizens, usually temporarily in the US, participating in foreign plans.
- •Termination of employment: Identifying so-called "specified employees" of publicly traded companies is mandatory with defaults for determination dates and covered periods. Payments to these individuals must be delayed six months if the trigger is termination of

employment.[89] Default date is December 31 with those identified treated as specified employees on the following April 1 for the ensuing 12-month period, April 1 to March 31. The final regulations provide some "safe harbors"' to ease identification.[90]

- Mistakes: There is not any mechanism for "fixing" mistakes. In the qualified plan area this used to be a huge problem, with the government developing curative programs over the last decade that now permit correction of any mistake other than "bad faith" types with little penalty. Treasury representatives express no appetite for developing a "fix" procedure.
- Settlements: If there is a dispute with a service provider, any settlement payments or benefits might be subject to § 409A, especially if there was a preexisting agreement for compensation.
- Separation from service: As this might be a trigger, determination of whether there has been such an event is critical. If there has not, and payment is made, there is a violation. If there has been, and payment is not made, there is a violation. In addition, two separations are possible for one service provider if that person is providing services both as an employee and as an independent contractor.
- Consents: Many arrangements cannot be unilaterally changed, although service recipients are likely to consent to changes that will reduce or eliminate an additional 20% tax. Assuming such consents must be obtained, the time for actually making the changes is reduced because of the need to submit to the service recipient.
- Securities laws: If changes are to be made to equity arrangements, consider whether the SEC tender offer rules are applicable and whether any S-8/prospectus changes are appropriate.
- "Buckets": Identify each type of arrangement and decide with what other arrangements it will be aggregated, as if one arrangement in the bucket is tainted all are tainted.

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89. *Id.* § 1.409A-1(c)(3)(v).
90. Treas. Reg. § 1.409A-1(n)(2)(ii) (2007).

- Payments in kind: Many will have to be modified to limit timing and integration with other arrangements. Generally, these cannot result in change to other payments and benefits.

APPENDIX II: SECTION 409A—THE "BUCKETS"

The following are the "buckets" set out under the final regulations:

1. Account Balance plans with respect to which a service provider elects to defer. This includes the portion of a combination plan that provides both elective and nonelective deferrals.
2. Account Balance plans that the service provider does not elect.
3. Non-Account Balance plans.
4. Separation Pay. This includes both voluntary and involuntary termination payments, but only those amounts that are only payable upon separation from service.
5. In-kind/Reimbursements.
6. Split Dollar Insurance.
7. Foreign Plans.
8. Stock Rights. These include partnership equity interest rights.
9. Default-All Other. Anything that does not fit in the above categories resides in this bucket.

APPENDIX III: SECTION 409A—EXEMPTIONS AND EXCLUSIONS

Qualified Employer Plans: Includes §§ 401(a), 457(b), 403(a), and 403(b).[91]

Foreign Plans: Includes plans excluded from income for US tax purposes, such as by treaty.[92] These exclude participation in broad-based plans by nonresident aliens, some foreign plan participation by US citizens and resident aliens, and totalization agreements under § 223 of the Social Security Act.[93]

Section 457: Some § 457(f) plans and certain others.[94]

Bona Fide Vacation Leave[95]

Bona Fide Sick Leave[96]

Bona Fide Compensatory Time[97]

Bona Fide Disability Pay: As defined in § 31.3121(v)(2)-1(b)(4)(iv)(C). Must be nontaxable.[98]

Death Benefit Plan: As defined in § 31.3121(v)(2)-1(b)(4)(iv)(C). Must be nontaxable.[99]

Medical Reimbursement Arrangements Satisfying §§ m105 and 106[100]

Amounts Excludible from Income[101]

Compensation Paid After Last Day of Year by Reason of Normal Payroll Practices[102]

Short Term Deferrals: Plan does not provide for a deferred payment in any circumstance and is paid within the applicable two and a half month period.[103]

Stock Options: If granted at fair market value exercise price and on service recipient stock. Must have no other feature for deferral of compensation.[104]

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91. Treas. Reg. § 1.409A-1(a)(2) (2007).
92. *Id.* §§ 1.409A-1(a)(3)(ii), (b)(8).
93. *Id.* §§ 1.409A-1(a)(3)(i)-(ii), (b)(8)(i).
94. *Id.* § 1.409A-1(a)(4).
95. *Id.* § 1.409A-1(a)(5).
96. *Id.*
97. Treas. Reg. § 1.409A-1(a)(5) (2007).
98. *Id.*
99. *Id.*
100. *Id.* § 1.409A-1(a)(5).
101. *Id.* § 1.409A-1(b)(1).
102. *Id.* § 1.409A-1(b)(3) (2007).
103. Treas. Reg. § 1.409A-1(b)(4).
104. *Id.* § 1.409A-1(b)(5).

SARs: If granted at fair market value exercise price and with respect to service recipient stock. Must have no other feature for deferral of compensation.[105]

Statutory Stock Options: §§ 422 and 423 grants.[106]

Restricted Property: A transfer of property subject to § 83, including restricted stock and an interest in a trust.[107]

Partnerships: Currently reserved in the regulations but preamble to regulations and notices provide that for the present apply the stock rules by analogy.[108] A transfer of a profits interest will be treated as exempt as a property transfer subject to § 83.[109]

Separation Pay Plans: Collectively bargained plans covering involuntary terminations or payments pursuant to a window plan; involuntary terminations and window plans subject to income cap and timing cap; foreign separation pay plans; certain reimbursements and in-kind benefits.[110]

Indemnification and Liability Insurance Plans: Covers both liability and expenses.[111] Also premiums for insurance.[112]

Legal Settlements: Only bona fide EEOC claims, etc.[113]

Educational Benefits: Only as described in § 127(c) and only for service providers, not family members.[114]

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105. *Id.* § 1.409A-1(b)(5)(i).
106. *Id.* § 1.409A-1(b)(5)(ii).
107. *Id.* § 1.409A-1(b)(6).
108. Preamble to Treas. Reg. § 1.409A, 72 Fed. Reg. 19234, 19243 (Apr. 17, 2007).
109. Treas. Reg. § 1.409A-1(b)(7) (2007).
110. *Id.* § 1.409A-1(b)(9)(ii).
111. *See id.* § 1.409A-1(b)(10).
112. *Id.*
113. *Id.* § 1.409A-1(b)(11).
114. *Id.* § 1.409A-1(b)(12).