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A Random Walk Down the Final Section 409A Regulations

Slogging through the nearly 400 pages of final Section 409A regulations is like walking away from a horrible auto accident, thinking "it could have been worse." It certainly is an improvement over the October 2005 proposed regulations. On the positive side, a lot of ambiguity was removed and some of the more unworkable rules, such as a lack of a good reason standard for a severance plan or the definition of service provider stock for private companies, are cleaned up. The new rules also create a permanent demand for compensation and benefits lawyers because every bonus program, employment contract, stock option plan, severance arrangement, and just about every other form of pay or perk can fall within the long reach of IRC Section 409A. Still, I can't help but notice that the car was totaled.

In this issue of *Benefits Law Journal*, you'll find a pithy and instructive discussion of IRC Section 409A's separation pay rules by Peter Marathas and a comprehensive overview of the entire regulations by Messrs. Pett, Stevens, and MacKay. I would like to point out some of ways that the Treasury and IRS made a bad tax law worse.

Overreacting to Enron executives' shoveling their deferred compensation into their pockets as the company cratered, Congress not only limited the mechanisms for funding and paying deferred compensation, but added several layers of statutory rules to the existing, largely judicial, constructive receipt/economic benefit doctrines. (Since executives are an easy target, Congress overlooked that encouraging executives to defer compensation actually is a long-term benefit for the National Treasury, as a large portion of the taxes on the deferrals will come due just as retiring baby boomers strain Social Security and Medicare entitlements.)

With the final regulations in hand and a looming January 1st compliance deadline, companies and executives are finding the new rules yet another annoying technical hoop to jump through. But the real trouble will come down the road, when IRC Section 409A's severe penalties for noncompliance begin to hit: a 20 percent excise tax plus interest on the tax that would have been paid from the time the compensation was vested. Added to the "regular" tax on the accelerated income, the combined tax, penalty, and interest hit could be huge, perhaps exceeding the actual compensation deferred. This is a very high price to pay for what, in some cases, could be relatively minor violations.

And there will be violations. Despite the relative clarity of the final regulations, there are now a huge number of new rules. Deferred compensation plans will start resembling qualified retirement plans in length and complexity. As with qualified plans, document and/or administrative mistakes will inevitably occur. Given the high cost and likelihood of a Section 409A violation, the Treasury and IRS should have used their discretion to limit the impact of the new law. Perhaps still smarting from their legendary failures over 60 years of litigating constructive receipt cases, the government was a bit gun-shy of the potential for Section 409A avoidance schemes by creative professionals. Whatever the reason, the final regulations go out of their way to add stricture to IRC Section 409A.

Practitioners have applauded the five new categories of plans that are added to the four originally set out in the proposed plan aggregation rules. But why do similar types of plans need to be aggregated at all? The concept of aggregation raises the stakes of Section 409A violation because a problem with one program will infect all the others of the same ilk. The rationale was the government's concern that employers would split their deferred compensation into multiple plans to limit the damage of non-compliance or perhaps to give executives extra flexibility. But IRC Section 409A will penalize any individual plan that runs afoul of the rules, so there is no need to attack programs that comply. After all, if an employer maintains two 401(k) plans and one plan fails to correct an ADP violation, the IRS will not seek to disqualify both plans.

The final regulations generously exempt "short-term deferrals," which are basically a delayed payment of vested benefits until March 15th of the following year. Further, if a plan "hardwires" the March 15th payment date in writing, a delay in payment until December 31st of the same year will be forgiven. But if the plan is unwritten or does not specify a payment date, missing the March 15th deadline is an automatic IRC Section 409A violation (unless the employee can prove constructive receipt of the money on March 15th). The Treasury and IRS were harsh to set such a trap for the unwary. There is no tax

or economic advantage to a calendar year taxpayer's receiving payment of compensation a bit later during the same year. Similarly, the regulations cut some, but not enough, slack on distributions that are "slightly" accelerated by 30 days or less. The regulations should have forgiven all early payments, as long as they were made in the correct taxable year. Every so often a company is likely to mess up its payroll, miscalculate a benefit, or neglect to make a distribution on time. Yet even an extra day late (or early) now will trigger huge IRC Section 409A tax obligations.

Real and perceived abuses have given stock options a bad name. The Section 409A regulations join the offensive by creating a per se violation for all discounted stock options. That is perhaps fair, but not for private companies with every intention of complying. The regulations devote many pages to determining the value of non-public stock, but do not provide any sure-fire method for setting market value. The final regulations should have adopted the good-faith valuation approach used for incentive stock options, so that an honest mistake in setting a strike price would not cause draconian tax penalties. Although options frequently are a key component of private company compensation strategy, they now are burdened with an extra and unnecessary tax risk.

Yet another wasted opportunity to make IRC Section 409A more workable are the payment election rules for a nonqualified plan that is paired with a qualified plan, such as a DB SERP. In a burst of generosity, the regulations do grant great flexibility in electing the form of payment (type of annuity), changes in beneficiary, and subsidized early retirement benefits. But they are downright unworkable in regard to when payment must begin. The final regulations require that the time of payment must be elected the year after the participant first accrues any benefit in the SERP. (Or, the year before any benefit accrues, if the SERP is not a pure excess plan.) Changes in timing after that are subject to the one year in advance, five-year deferral requirement. This could end up requiring an employee to decide at the tender age of 40 when to begin receiving SERP retirement benefits. A better approach would have allowed the payment election under the qualified plan to govern the SERP as well.

Another obvious aide to compliance rejected by the regulations was the addition of a "savings clause" provision to all plan documents. Before the final Treasury Regulations came out, many practitioners were inserting language in plans along the lines of, "Notwithstanding anything else to the contrary, if we goofed and left something out or incorrectly interpreted the rules of IRC Section 409A, the Section 409A rules trump the plan terms." The government rejected this fail-safe because it wants every program or agreement to set out all the rules of governance. Treasury and IRS personnel also have stated that IRC

Section 409A is too complicated for them to issue model provisions and that they do not have the resources for a determination letter program for nonqualified plans. In fact, as long as the operation of a plan is in compliance with IRC Section 409A, there is no harm in "document malfunction." As deferred compensation plans come increasingly to resemble qualified plans in complexity—but without the protection of remedial amendment periods, determination letters, or pre-approved prototype plans—fail-safe language would have proven particularly meaningful.

The final regulations do offer a blueprint for drafting and administering most types of deferred compensation plans, although we are still waiting for guidance for plans offered by partnerships. By hardwiring payment dates, limiting discretion, avoiding pariahs such as discounted stock and certain perks, and adopting the IRS safe harbor definitions, it is now possible to build an Section 409A-compliant deferred compensation plan. While most programs will be in compliance most of the time, as happens with qualified plans, it is inevitable that even the most cautious employer may end up with defects in its programs from time-to-time, and the final regulations make errors more likely. The Preamble indicates the Treasury and IRS are at work on guidance of the calculation of penalties. Having missed one opportunity, they should use this forthcoming guidance to lessen the impact of minor violations.

As a final note, I would advise executives to exercise caution before voluntarily deferring any compensation, given the standard non-payment risks, the intense scrutiny of the compensation paparazzi, and the increased potential of Section 409A sanctions (not to mention the possibility of a tax rate increase by the next Administration). That's a lot of downside risk, just to put off paying the taxman.

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