K&LNG Alert

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Compensation & Benefits

Proposed Section 409A Regulations: Payment Elections and Payment Triggers

This is the second in a series of four Alerts that provide a detailed summary of the provisions of the Proposed Regulations issued by the Internal Revenue Service under Section 409A of the Internal Revenue Code on September 29, 2005. Section 409A, enacted by the American Jobs Creation Act of 2004, imposes substantial new rules on nonqualified deferred compensation arrangements.

This Alert focuses on the provisions of the Proposed Regulations that relate to the form and timing of payments from nonqualified deferred compensation plans. Our prior Alerts summarizing the Proposed Regulations can be accessed through the following links:

- General Summary
- Determination of Arrangements Subject to 409A

Our final two Alerts, which will be published in the near future, will provide a detailed summary of (i) the rules relating to deferral elections and (ii) effective dates, grandfathering issues and transition relief under the Proposed Regulations.

TIMING AND FORM OF PAYMENT

Section 409A provides that payment from a nonqualified deferred compensation plan may be made only at a fixed date or pursuant to fixed schedule, or following the occurrence of one of five events: (i) separation from service, (ii) death, (iii) disability, (iv) change in ownership or effective control of a corporation, and (v) unforeseeable emergency. The Proposed Regulations provide a substantial amount of guidance on many of these payment triggers.

Timing of Payments Following Payment Event

Many employers and deferred compensation plan participants[1] have been concerned that, where payment under a deferred compensation plan is made upon a permissible event (i.e., separation from service, death, disability, change in ownership or effective control or unforeseeable emergency), the payment must be made within a particular time frame following the occurrence of the event. The Proposed Regulations make clear that payment may be made at any time after the event provided that the plan designates an "objectively determinable" date or year following the event upon which the payment is to be made. For example, a deferred compensation plan could provide that payment will be made 30 days following a separation from service or upon the first anniversary of a participant's death.

Fixed Date or Fixed Schedule Payments

With respect to payments made on a fixed date or pursuant to a fixed schedule, a Plan need not specify the exact date within a calendar year in which the payment is to occur. Rather, a plan may specify the calendar year or years in which payment will be made, in which case, payment may be made at any time during that calendar year or years. As discussed below, where the date of a payment is specified by year, the

[1] Section 409A generally applies to all service providers, including employees and independent contractors. The Proposed Regulations use the term "service provider" to describe the individual or entity providing the services and the term "service recipient" to describe the individual or entity for whom the services are provided. Because those terms can be somewhat cumbersome and because most deferred compensation arrangements arise in the employment context, this Alert generally refers to "service providers" as "participants" and service recipients as "employers."

payment will be deemed scheduled for payment on January 1 of that year for purposes of the rules that allow a participant to make a subsequent election to defer payment.

The Proposed Regulations also clarify that a plan satisfies the "specified time" or "fixed schedule of payments" distribution trigger where it provides at the time of deferral that the payment will be made at a date or dates that are objectively determinable following the occurrence of a vesting event. For example, where a participant becomes vested in his or her right to deferred compensation upon the occurrence of an initial public offering, the plan may provide that payment may be made on one or more anniversaries of the public offering.

Separation From Service

Employees

An employee will be deemed to have experienced a separation from service when he or she dies, retires or otherwise has a termination of employment with the employer and all companies affiliated with the employer under the "controlled group" rules of the Internal Revenue Code. Military leave, sick leave and other bona fide leaves of absence will not constitute a separation from service if the period of leave does not exceed six months, or, if longer, so long as the employee's right to reemployment is provided by statute or contract. The determination of whether an employee has experienced a termination of employment will be made using a facts and circumstances test.

An employee who continues to render "significant services" to the employer will not be deemed to have terminated employment. Significant services exist where (i) the employee provides services at an annual rate equal to at least twenty percent of the services rendered, on average, during the immediately preceding three full calendar years of employment and (ii) the annual remuneration from such services is equal to twenty percent of the average remuneration earned during the immediately preceding three full calendar years of employment. Under this rule, an employee need not actually terminate employment with the employer to trigger a separation from service; rather, it will be sufficient if the employee reduces his or her workload by approximately 80%. Additionally, where an employee continues to provide services for his or her former employer in a capacity other than as an employee (e.g., as an independent contractor or as a director), a separation from service will be deemed to have occurred only if the former employee provides services at an annual rate that is fifty percent or less of the services rendered, on average, during the final three full calendar years of employment and the annual remuneration for such services is fifty percent or less of the average annual remuneration earned during the immediately preceding three full calendar years of employment.

Independent Contractors

An independent contractor will be deemed to have experienced a separation from service upon the expiration of the contract, or, if applicable, all contracts, under which services are performed for the employer if the expiration constitutes a good-faith and complete termination of the contractual relationship. A separation from service will generally not be found where the employer intends to renew the expired contract. An employer will be deemed to anticipate renewal if it intends to contract for the same services and neither the employer nor the independent contractor has eliminated the independent contractor as a possible provider of the services under the new contract or if future services by the independent contractor are contingent upon the employer's having a need for the services. Under a "safe harbor" rule, payment will be deemed made following an independent contractor's separation from service following expiration of the contract between the employer and the independent contractor if (i) the contract provides that no amount will be paid to the independent contractor within 12 months after the date the contract expires (or the date all contracts expire) and (ii) the independent contractor does not perform any services (as an independent contractor or as an employee) between the date the contract terminates and the date of payment.

The Proposed Regulations do not have any separate rules for directors. Although directors are generally treated for most tax purposes as independent contractors, the independent contractor separation from service rules (which focus on terminations of contracts) would not appear to have any logical application for directors who generally do not serve under contract. Accordingly, it is not entirely clear whether an individual who serves as both a director and an employee of a corporation has a separation from service with respect to his or her director deferred compensation arrangements when that individual terminates service as a director, but continues to provide service as an employee.

Key Employees

Section 409A provides that where payment under a nonqualified deferred compensation plan is triggered by a separation from service, no payment to a "key employee" of a publicly traded company may be made during the six-month period following the separation from service. Key employees are, generally, (i) officers with annual compensation that exceeds $135,000 (for 2005), (ii) 5% owners of the employer and (iii) 1% owners of the employer with annual compensation that exceeds $150,000. Many employers have been concerned that because the universe of key employees changes from year to year, and because the universe of key employees cannot always be identified precisely on the first day of each year, it would be difficult, if not impossible, to know who the employer's key employees are at the beginning of each year. The Proposed Regulations provide employers with some needed flexibility in this area. Specifically, the Proposed Regulations provide that the key employee determination must be made based upon the 12-month period ending on an identification date chosen by the service recipient. If no date is designated, the default identification date will be December 31. Individuals who meet the definition of key employee during this period will be considered key employees for the 12-month period commencing on the first day of the fourth month following the end of the 12-month period. For example, an employer that determines key employees on the basis of a January 1 – December 31 plan year would identify its key employees for 2005 and apply the six-month delay to those employees for the period April 1, 2006 through March 31, 2007.

Employers and employees have flexibility in determining how to implement this six-month delay and may provide that any payment subject to this provision be delayed in its entirety until the end of the six-month period, or that each scheduled payment that becomes payable pursuant to a separation from service must be individually delayed six months, or a combination thereof. The plan may allow the employee to elect the manner in which the delay will be implemented, provided that the election otherwise complies with Section 409A.

Finally, when a formerly private company becomes subject to the six-month delay requirement, the Proposed Regulations provide that the plan may be amended to specify or change the manner in which the delay will be implemented, effective immediately upon adoption of the amendment. Otherwise, any change in the manner in which payments that would otherwise be made during the six-month period can be effective no earlier than 12 months after the change is adopted.

Disability

Under Section 409A, in order to receive payment from a nonqualified deferred compensation plan on the basis of "disability," the employee must, by reason of any medically determinable physical or mental impairment that can be expected to result in death or to last for a continuous period of at least 12 months, either (i) be unable to engage in any substantial gainful activity, or (ii) be receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the employer. The Proposed Regulations clarify that a plan that provides for a payment upon disability need not provide for payment upon all permissible disabilities. Additionally, the Proposed Regulations permit the plan to rely on a Social Security Administration determination of disability or a disability determination under a disability insurance program under which the definition of disability is otherwise consistent with the Section 409A definition.

Change in Control

In Notice 2005-1, the Internal Revenue Service established a preliminary set of rules for determining when payment of nonqualified deferred compensation may be paid on the basis of a change in control. The Proposed Regulations leave the definition of change in control substantially unchanged from the prior guidance. Under the Proposed Regulations, a change in control occurs under the following circumstances:

- A sale of stock of the employer that causes the buyer to hold more than 50% of the employer's stock (determined on total fair market value or total voting power basis).
- A buyer's acquisition of more than 35% of the employer's stock during any 12-month period (determined on a total voting power basis).
- A hostile replacement of a majority of the employer's board of directors during any 12-month period.

- A buyer's acquisition of more than 40% of the employer's assets during any 12-month period.

A change in control does not necessarily refer to a change in control of the entire group of affiliated employers. Thus, the relevant analysis for purposes of Section 409A centers on whether a change in control event occurs with respect to (i) the employer for whom the employee performed services at the time of the event, (ii) the employers liable for the payment at the time of the event, or (iii) a majority owner of one of these employers.

The Proposed Regulations permit the change in control provisions to be applied to partnerships, subject to the issuance of further guidance.

The Proposed Regulations also address the impact of Section 409A on earn-out provisions. Under the Proposed Regulations, compensation payable pursuant to a change in control of a company may be treated as paid at a specified time or pursuant to a fixed schedule as required by Section 409A, provided that these amounts are paid on the same schedule and under the same terms and conditions as payments to other shareholders and not later than five years after the change in control event.

Unforeseeable Emergencies

The Proposed Regulations substantially adopt the definition of unforeseeable emergency contained in the statute. Thus, a participant in a nonqualified deferred compensation plan may receive payment of an amount reasonably necessary to satisfy the participant's severe financial hardship resulting from (i) an illness or accident of the participant or the participant's spouse or dependent, (ii) the loss of the participant's property due to casualty, or (iii) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The beneficiary of a participant may also qualify for unforeseeable emergency payments following the death of the participant. The amount payable may include the amount of reasonably anticipated taxes or penalties applicable to the payment.

The Proposed Regulations state that a plan may provide that a deferral election will terminate if a service provider obtains a payment upon an unforeseeable emergency. Likewise, a plan may now provide that a deferral election will be terminated if to do so is required for a participant to obtain a hardship distribution under a 401(k) plan. However, in both instances, the deferral election must be terminated and not merely suspended. A deferral election made after the termination of a previous deferral election due to an unforeseeable emergency will be treated as an initial deferral election.

Multiple Payment Events

The Proposed Regulations make clear that plans may provide for payments to be made upon the earlier of, or later of, two or more specified permissible payment events or times. Additionally, a different form of payment may be elected for each potential payment event. For example, a plan can provide that payment will be made upon the earlier to occur of the date specified by the participant or the participant's separation from service and that payment on the specified date will be in a lump sum and payment on separation from service will be in installments.

Delay in Payment

The Proposed Regulations provide that a payment from a deferred compensation plan may be delayed beyond the date on which payment would otherwise be made in a variety of circumstances.

Short-Term Delays

A payment under a nonqualified deferred compensation plan will be deemed paid on the date otherwise designated for payment if it is paid at any time during the same calendar year or, if later, by the 15th day of the third calendar month following the designated date of payment. For example, if a deferred compensation plan provides that payment will be made upon a participant's separation from service and the participant separates from service on June 1, 2007, payment may be made as late as December 31, 2007. If the participant separates from service on November 1, 2007, payment may be made as late as February 15, 2008.

Administrative Impracticability

If calculation of the amount of a payment is not administratively practicable due to events beyond the control of the participant (or the participant's estate), the payment will be treated as made on the designated date if the payment is made during the first calendar year during which payment is administratively practicable.

Employer's Insolvency

If the employer has insufficient funds and cannot, therefore, make payment on the designated date without jeopardizing the employer's solvency, the payment will be treated as made on the designated date if payment is made during the first calendar year in which the employer's funds are sufficient for payment without jeopardizing its solvency.

Disputed Amounts and Refusal to Pay

The Proposed Regulations provide that, where an employer refuses to pay deferred compensation when payment is due, and where a participant is acting in good-faith and makes good faith efforts to collect payment, the payment will be deemed to have been made on the date scheduled under the terms of the plan. Payment must then be made by the later of the end of the calendar year in which, or the 15th day of the third month following the date that, the employer and the participant enter into a legally binding settlement of the dispute, the employer concedes the amount is payable or the employer is ordered to make such payment pursuant to a final judgment.

162(m) Deductibility

The Proposed Regulations permit payment to be delayed beyond the date payment would otherwise be made under the plan where the employer's ability to deduct the payment as compensation would be limited or eliminated as a result of Section 162(m) of the Internal Revenue Code (which limits the annual deductible nonperformance-based compensation of certain executives to $1,000,000). In the event of such a delay, payment must be made at the earliest date on which the employer reasonably anticipates that the Section 162(m) limitation will not prevent deductibility of the payment or the calendar year in which the participant separates from service. This delay is permitted only to the extent permitted by the terms of the plan. A plan may be amended to add a Section 162(m) delay provision, but the effective date of any such amendment must be delayed for at least 12 months.

Loan Covenants and Other Arrangements

The Proposed Regulations permit payment to be delayed beyond the date payment would otherwise be made under the plan where the employer reasonably anticipates that the payment would violate a term of a loan agreement to which the employer is a party (e.g., a financial covenant to a bank) or other similar contract to which the employer is a party. In the event of such a delay, payment must be made at the earliest date on which the employer reasonably anticipates that the payment will not cause the violation, or that the violation will not cause the employer material harm. The employer must be able to demonstrate that it entered into the agreement that prevents the payment for legitimate business reasons and not as a mechanism for enabling the employer to avoid making the scheduled payment. This delay is permitted only to the extent permitted by the terms of the plan. A plan may be amended to add a contract-violation delay provision, but the effective date of any such amendment must be delayed for at least 12 months.

Federal Securities and Other Applicable Laws

The Proposed Regulations permit payment to be delayed beyond the date payment would otherwise be made under the plan where the employer reasonably anticipates that payment would violate federal securities laws or other applicable law. In the case of such a delay, payment must be made at the earliest date on which the employer reasonably anticipates that the payment will not violate the law. This delay is permitted only to the extent permitted by the terms of the plan. A plan may be amended to add a violation-of-law delay provision, but the effective date of any such amendment must be delayed for at least 12 months.

ANTI-ACCELERATION CLARIFICATIONS

Section 409A generally prohibits the acceleration of payments to any date prior to the date or event on which payment would otherwise be made under the terms of the plan. The Proposed Regulations confirm a number of exceptions to the anti-acceleration rule originally adopted in Notice 2005-1:

- Payment may be made to the extent necessary to comply with a domestic relations order.
- Payment may be made to the extent necessary to comply with federal conflict-of-interest divestiture rules.
- Payment may be made under a nonqualified deferred compensation plan of a state or local government or nonprofit organization (i.e., a Section 457(f) plan) to the extent necessary to pay income tax withholding due in connection with the vesting of the compensation deferred under the plan.

- A plan may be amended to require that payment of all of a participant's benefits under the plan (to the extent not greater than $10,000) will be made upon separation from service in a lump sum no later than December 31 of the calendar year in which the participant separates from service or the 15th day of the third month following the participant's separation from service.
- Payment may be made to the extent necessary to pay payroll taxes on compensation deferred under the plan.

The Proposed Regulations also permit the acceleration of the time or schedule of a payment to a participant to pay the amount the participant must include in income as a result of a Section 409A violation. The participant will be deemed to have included the amount in income only if the amount is timely reported on a Form W-2 or Form 1099-MISC.

The Proposed Regulations further permit accelerated payment of deferred compensation benefits upon a termination of the plan under which the compensation is deferred in three instances:

- A plan may be terminated where an employer wishes to cease providing a specific category of nonqualified deferred compensation entirely. In this situation, all arrangements of the same type must be terminated with respect to all participants, no payment other than those required under the terms of the plan absent a termination may be made within twelve months of the termination, all payments must be made within twenty-four months of the termination, and the employer cannot adopt a new arrangement that would be aggregated with any terminated arrangement under the plan aggregation rules at any time for a period of five years following the date of termination.
- A plan may also be terminated, and payments made, within twelve months following certain corporate dissolutions or with the approval of a bankruptcy court, provided that the amounts deferred are included in the participants' gross income by the latest of (i) the calendar year in which the plan termination occurs, (ii) the calendar year in which the amount is no longer subject to a substantial risk of forfeiture (i.e., becomes vested); or (iii) the first calendar year in which the payment is administratively practicable.
- A plan may be terminated within 30 days before and 12 months after a change of control, provided that all substantially similar arrangements sponsored by the employer are terminated, and provided that all participants under all such arrangements receive payment within 12 months of the date of termination.

Finally, the Proposed Regulations provide that accelerated payments are permissible to the extent necessary to permit allocations under Section 409(p) of the Internal Revenue Code to certain "disqualified persons" under an employer stock ownership plan (ESOP) sponsored by the employer. The amount distributed must not exceed 125% of the minimum amount of distribution necessary to permit the ESOP allocation.

SUBSEQUENT CHANGES IN TIME AND FORM OF PAYMENT

Under Section 409A, a participant may elect to change the form and/or timing of payment established at the time of initial deferral provided that (i) the election may not become effective for a period of at least 12 months after the date on which the election is made, (ii) in the case of payments otherwise due on a fixed date or pursuant to a fixed schedule or pursuant to a separation from service or following a change of control, the first payment may be made no earlier than five years from the date such payment would otherwise have been made and (iii) in the case of payments that would otherwise be paid on a fixed date or pursuant to a fixed schedule, the election is made at least 12 months prior to the date of the first scheduled payment.

Definition of Payment

The Proposed Regulations address the issue of whether individual amounts paid in a defined stream of payments, such as installment or annuity payments, will be treated as separate payments or as one payment for purposes of applying the subsequent deferral election and anti-acceleration rules. The Proposed Regulations provide that each separately identified amount to which a service provider is entitled on a determinable date is eligible for treatment as a separate payment. Installment payments will generally be treated under the Proposed Regulations as a single payment which occurs on the date of the first installment. A series of installment payments may alternatively be treated as a series of separate payments if the plan so provides. Regardless of the treatment, installment payments must comply with the rules governing subsequent changes in the time and form of payment. For example, where installment payments are to be treated as a single payment, it would be permissible for a service provider to change an installment payment that is initially scheduled to be made on an annual basis for five years beginning in 2010 to a lump sum payment payable in 2015. Under the same scenario, but where the plan provides that installment payments are to be treated as separate payments, the earliest a lump sum payment could be made is 2019, five years following the date the last separate installment payment was to have been made.

Life annuities must always be treated as a single payment. Elections by participants to change the form of payment from one type of life annuity to another type of actuarially equivalent life annuity (e.g., a change from a single life annuity to a joint and survivor annuity) is not subject to the election change rules. Therefore, such an election change need not be delayed for one year and need not postpone the commencement date of the annuity for five years. Actuarial equivalence must be determined on the basis of reasonable actuarial assumptions.

Multiple Payment Events

The Proposed Regulations also address how the subsequent election provisions will apply where the plan permits payment to be made upon the earlier of, or the later of, multiple specified permissible payment events with possibly multiple forms of payment as well. In this situation, the subsequent election provisions are to apply to each payment event separately. However, where a participant wishes to add a new payment event or fixed time or fixed schedule of payments for an amount previously deferred, this addition will be subject to the rules governing changes in the time and form of payment and the anti-acceleration rules. This means that no fixed time of payment may be added that does not defer the payment at least five years from the date the fixed time or payment was added.

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