Let's Look at the Big Picture: Partnership Compensation Issues from the Partnership and Benefits Perspective

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I. INTRODUCTION

The use of pass-through entities has been steadily increasing. At the same time, use of equity and equity-based compensation continues to be popular, and in many industries is a standard part of a competitive compensation package. The key provisions of the Code related to the tax treatment of compensation were developed when operating businesses were significantly more likely to be corporate entities, and it is not always clear how those provisions apply in the pass-through context. In some areas, such as qualified plans and fringe benefits, there have been legislative and regulatory changes that have reduced the extent to which there are differences in the benefits that can be provided based on whether the plan sponsor is a partnership or a corporation. There has not been the same comprehensive approach to equity compensation. This outline reviews the basic provisions governing the taxation of equity and equity-based compensation and their application in the pass-through context.

II. STATUS AS AN EMPLOYEE

A. Restriction on Dual Status

The longstanding IRS position is that an individual cannot be both an employee and a partner in a partnership. Although section 707(a) recognizes that a partner can act in a non-partner capacity, the IRS has taken the position that this section applies only to circumstances in which the partner’s services are not related to the trade or business of the partnership. For example, section 707(a) would apply if a partner in a law firm partnership provides architectural services designing the firm’s new offices. In contrast, if a lawyer is admitted as a partner and continues to provide legal services, the IRS’s view is that he or she cannot also be an employee of the firm. More specifically, Treas. Reg. section 1.707-1(c) states that guaranteed payments for services cannot be wages.

B. Income Tax Treatment of a Partner or Employee

1. Federal income tax

An employee who is issued equity in the partnership for which he or she works will become a partner in that entity for all purposes, even if the individual continues to receive the majority of his or her compensation in a form that looks like a salary. Salary and annual bonus shift from being reported on Form W-2 and subject to FICA tax to being reported on Schedule K-1 and subject to SECA tax. Section 1402(a)(13) states that guaranteed payments for services constitute self-employment income in all cases. In addition, federal income tax withholding is no longer applicable; therefore, the partner will be required to pay estimated tax during the year.

2. FICA and SECA

An employee and his or her employer each pays 6.2% in FICA taxes on amounts up to the annual wage base ($118,500 for 2016), and each pays 1.45% on all wages for the year, for a total combined tax of 15.3%, increased beginning in 2013 by an additional .9% on wages exceeding $200,000 ($250,000 for married taxpayers filing jointly). In contrast, a partner is responsible for SECA tax on the full combined rate of 15.3%, with a deduction for 7.65%, as well as the additional .9% on net income from self-employment.

1 Except as otherwise provided, references to the Code are to the Internal Revenue Code of 1986, as amended.

2 Rev. Rul. 69-184; see also GCM 34001 and GCM 34173. Rev. Rul. 69-184 was cited in the preamble to the proposed regulations regarding disguised payments for services. 80 Fed. Reg. 43652, 43654.
For the most part, the timing of FICA and SECA tax is the same—both are assessed at the time the amounts are included in income. For FICA purposes, the tax is due as amounts are included in employee wages, generally when these amounts are paid to the employee. For SECA purposes, the tax is due as the amounts are included in self-employment income. There is, however, one key timing difference between the two systems that is related to nonqualified deferred compensation. Under section 3121(v), FICA tax is due on deferred compensation when the amount becomes substantially vested or, if later, when reasonably ascertainable. There is no analogous provision in the SECA regime. If a deferred compensation plan is account-based, meaning that the amount payable under the plan is calculated using a principal amount credited (or debited) with income, the benefit under the plan is included in wages for FICA purposes at vesting. For a deferred compensation plan other than an account-based plan, amounts are not included in wages until reasonably ascertainable, defined as the point at which the amount, form, and commencement date of the benefit is known, with the only remaining actuarial assumptions related to interest and mortality. For nonaccount balance plans, there is an early inclusion mechanism, subject to true-up once amounts become reasonably ascertainable.

As a result of these FICA rules, if an employee is granted nonqualified deferred compensation that vests while he or she was an employee, FICA may have been paid at vesting, depending on the design of the plan and whether early inclusion was applied. If the employee is a partner at the time amounts are actually paid and included in income and if those amounts are to be reported on a Schedule K-1, they would appear to be subject to SECA tax—an inequitable result, as employment taxes have already been paid. There is no clear guidance on how to report the income. Although the same individual generally would not receive a W-2 and a K-1 from the same entity, in this case, because the compensation was fully earned through services as an employee, it may be appropriate to issue a W-2 in the same way the employer would report for any other former employee. An alternative approach would be to report the amounts on the Schedule K-1 but exclude them from SECA tax.

3. State Tax

An employee must file a state income tax return in the state of his or her residence and may have to file in other states, based on his or her level of individual connection with the state. In contrast, a partner will generally be required to file in each state in which the partnership has income.

C. Qualified Retirement Plans

Qualified retirement plans are plans that comply with section 401(a) and related requirements. Contributions to these plans are deductible by the employer when made, but income inclusion for the participant is deferred until distributions. Qualified plans include defined benefits plans, pursuant to which the benefit provided is determined by a formula, and defined contribution plans, pursuant to which the benefit is based on an account credited with earnings (or losses).

Historically, partners were not eligible to participate in qualified retirement plans to the same extent as employees. A series of legislative changes have made this treatment more equal, with a few exceptions noted below.

The first exception relates to the difference between an exclusion for employees and a contribution with a deduction for self-employed individuals. As with other types of benefits, while contributions to a qualified retirement plan are excluded from income for an employee, they are treated as guaranteed payments on Schedule K-1 for partners, with an offsetting deduction depending on the type of contribution (e.g., 401(k) contribution, matching or profit sharing contribution, or contribution to a defined benefit plan).

With regard to defined contribution plans, Treas. Reg. section 1.404(e)-1A(f)(1), specifically states that such contributions are to be separately stated items for purposes of section 702(a)(8):

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3 I.R.C. § 3101.
4 I.R.C. § 1401
5 Treas. Reg. § 31.3121(v)(2)-1(c).
6 See, e.g., I.R.C. § 401(c) (treating self-employed individuals as employees for purposes of section 401(a)).
For purposes of sections 702(a)(8) and 704 in the case of a defined contribution plan, a partner’s distributive share of contributions on behalf of self-employed individuals under such a plan is the contribution made on his behalf, and his distributive share of deductions allowed the partnership under section 404 for contributions on behalf of a self-employed individual is that portion of the deduction which is attributable to contributions made on his behalf under the plan. The contribution on behalf of a partner and the deduction with respect thereto must be accounted for separately by such partner, for his taxable year with or within which the partnership’s taxable year ends, as an item described in section 702(a)(8).

With regard to defined benefit plans, Treas. Reg. section 1.404(e)-1A(f)(2), doesn’t include the same language, instead:

In the case of a defined benefit plan, a partner’s distributive share of contributions on behalf of self-employed individuals and his distributive share of deductions allowed the partnership under section 404 for such contributions is determined in the same manner as his distributive share of partnership taxable income. See section 704, relating to the determination of the distributive share and the regulations thereunder.

In many cases, a partnership will want contributions on behalf of self-employed individuals, or the deductions for contributions for employees, to a defined benefit plan to be allocated in a manner different from the general allocation of distributive share, and so may provide for a different allocation method for these contributions, deductions, or both.

One point that remains different is the application of the overall limits on contributions and deductions. With respect to employees, these limits are based on definitions of compensation set out in the Code. “Compensation” does not include, among other things, contributions to the qualified plans themselves, except for elective deferrals under a qualified plan, which are added back in. So, for example, the maximum annual contribution to defined contribution plans (section 401(k) and employer sponsored account balance plans) is the lesser of $40,000 (currently adjusted to $51,000 for 2013) or 100% of the participants “compensation,” which includes section 401(k) elective deferrals. For partners, however, compensation means net earnings from self-employment (generally speaking, guaranteed payments plus distributive share of the partnership taxable income or loss that is treated as self-employment earnings). This amount is reduced for any contributions to a qualified plan, including elective deferrals and other contributions. The same definitions control for purposes of section 404 and the limits on deduction. As a result, the limit as applied to a partner could be lower than it would be for an employee with a compensation package that is otherwise of the same economic value.

While the qualified plan rules in the Code allow participation in qualified plans by partners, it is important that the specific plan is drafted to allow such participation—both to ensure that the right entities are participating in the plan and that self-employed individuals are eligible to participate.

D. Health Coverage

As with retirement benefits, health benefits are not excludible for partners; instead, the cost of the coverage is a guaranteed payment to the individual with a deduction allowed for self-employed health premiums under section 162(l). Because section 162(l) applies to premiums, there has been some question about the ability of a partner to deduct coverage through a self-funded health plan. Consistent with the legislative history, the IRS has allowed these plans to be treated in the same way as insured plans, based on arrangements that provide for risk shifting and pooling akin to insurance such that section 162(l) applies.7

In contrast, partners are not eligible to participate in a cafeteria plan, which allows employees to elect to set aside amounts on a pre-tax basis for things such as health expenses or dependent care expenses (through separate elections).

E. Fringe Benefits

Eligibility for some fringe benefits is the same for a partner as it is for an employee. This is true of no additional cost service, qualified employee discounts, working condition fringe

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7 Priv. Ltr. Ruls. 200704017, 200007025.
benefits, and de minimis fringe benefits. Partners are not, however, eligible for similar treatment for qualified transportation or qualified moving expense reimbursement.\(^8\)

F. **Retaining Status as an Employee**

In many cases, an individual would prefer to continue to be classified as an employee and avoid the administrative complexities of being a partner for tax purposes. One solution is to provide equity-based compensation, rather than a transfer of equity ownership. Advantages to this approach include preserving employee status for the individual while providing compensation that is tied to the performance of the business as a whole. While the individual has ordinary income, the employer is entitled to a deduction. Other alternatives are available for situations in which there are multiple entities within an overall structure, as an individual can have a different status with the various entities. Thus, for example, an individual may perform services as an employee for one entity, and receive a W-2, while owning equity, and receiving a Schedule K-1, from an upper-tier entity. Advantages of this type of arrangement structure include continued employee status for compensation while providing the individual with an actual equity ownership as well.

As discussed further below, however, the proposed regulations regarding disguised payments for services would change the treatment of transfers of profits interests in some situations in which an individual is performing services for one entity while receiving equity in a different entity.

III. **TRANSFERS OF COMPENSATORY PARTNERSHIP INTERESTS**

A. **Section 83**

Section 83(a) applies to the transfer of property in connection with the performance of services. The excess of the fair market value of the property over the amount paid, if any, by the service provider is includible in the gross income of the service provider when the property is either "transferable" or not "subject to a substantial risk of forfeiture."\(^9\) Section 83(h) allows a corresponding deduction to the service recipient.

The rights of a person in property are "subject to a substantial risk of forfeiture" if such person’s rights to full enjoyment of such property are conditioned upon the future performance of substantial services of any individual or on the occurrence of a condition related to the purpose of the transfer of the property.\(^9\) In either case, whether a risk of forfeiture is substantial is based on all of the facts and circumstances.

For section 83 purposes, property is "transferable" if the property is subject to a substantial risk of forfeiture while held by the service provider, but not if the property is transferred to a third party.\(^10\)

Section 83(b) permits a service provider to elect to recognize compensation income, if any, measured at the time of transfer rather than when property becomes substantially vested. A section 83(b) election must be filed with the IRS no later than 30 days after the date of transfer of the interest and once properly filed, cannot be revoked except in unusual circumstances. Errors in determining the fair market value of the property or in appreciating the consequences of the section 83(b) election do not provide a basis for revoking a section 83(b) election. In addition to being filed with the IRS, the election must be given to the service recipient and must be attached to the service provider’s return for the taxable year of transfer. Failure to attach the election to the return for the year, however, does not operate as a de facto mechanism to revoke an otherwise valid election.\(^11\)

The income under section 83 is equal to the fair market value of property over the amount paid, if any. If an individual pays fair market value for unvested property and files a section 83(b) election, he or she will not realize compensation income. The section 83(b) election is still required in those circumstances, however. Paying full fair market value for the property at grant does

\(^8\) Treas. Reg. § 1.132-1(b).

\(^9\) Treas. Reg. § 1.83-3(c).

\(^10\) Treas. Reg. § 1.83-3(d).

not affect the application of section 83; rather, the payment affects the amount potentially included in income at vesting.\(^1\)

**B. Rev. Procs. 93-27 and 2001-43**

The IRS has issued specific guidance related to the transfer of partnership interests, such that the basics of the tax treatment of transfers of compensatory equity interests has been established for several years. The issuance of Rev. Procs. 93-27 and 2001-43 established a framework for tax treatment of compensatory transfers of partnership equity, resolving the issues raised by the Diamond and Campbell cases. Under these two procedures, compensatory transfers of partnership interests are divided into two types by reference to whether the holder would be entitled to a payment upon liquidation:

**Capital Interest:** An interest that would give the holder a share of liquidation proceeds if, immediately after the interest is granted, the partnership’s assets were sold at fair market value, its liabilities were satisfied, and the remaining proceeds were distributed in a complete liquidation of the partnership.

**Profits Interest:** An interest that is not a capital interest.

The transfer of a capital interest to a service provider is a transfer in the nature of compensation subject to generally applicable rules under section 83. Prior to vesting, or a section 83(b) election, a capital interest is not treated as outstanding and does not receive a distributive share of partnership tax allocations. Payments made to an individual with respect to an unvested interest are treated as employee compensation if the individual is not otherwise a partner. If the individual is a partner, payments made with respect to the unvested capital interest are treated as a guaranteed payment. Rev. Proc. 93-27 provides that transfer of a profits interest to an individual providing services to or for the benefit of the partnership does not result in a taxable event for the partner or the partnership. However, exceptions to this safe harbor exist. Rev. Proc. 93-27 does not apply if (1) the profits interest relates to substantially certain/predictable stream of income from partnership assets (e.g. debt securities), (2) the recipient disposes of the interest within two years of receipt, or (3) the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of section 7704(b).

Rev. Proc. 2001-43 was issued to “clarify” Rev. Proc. 93-27. It provides for the same result—the transfer of a profit interest is not a taxable event—even if the profits interest is unvested at the time of transfer, provided all the conditions of Rev. Proc. 93-27 are satisfied and the recipient of the profits interest is treated as a partner from the date of grant. The service recipient must not claim a deduction, at grant or vesting. Rev. Proc. 2001-43 further provides that the vesting of a profits interest also will not be treated as a taxable event, obviating the need for a section 83(b) election at the grant of the unvested profits interest.

The preamble to the proposed regulations related to disguised payments for services includes a statement that the Treasury Department and the IRS intend to add an exception to Rev. Proc. 93-27 that would exclude interests transfer to a partner who is forgoing “payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under section 707(c) or a payment in a non-partner capacity under section 707(a).”\(^1\)

**C. Fair Market Value**

The term “fair market value” is not specifically defined for purposes of section 83. The generic definition for U.S. federal income tax purposes is the willing buyer-willing seller test: “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”\(^1\)

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\(^1\) Alves v. Comm’r, 734 F2d 478 (9th Cir., 1984).

\(^2\) Campbell v. Comm’r, 943 F.2d 815 (8th Cir. 1991); Diamond v. Comm’r, 492 F.2d 286 (7th Cir., 1974).

\(^3\) 80 FR 43652, 43656.

Courts sometimes use this definition as a starting point in section 83 cases and modify it as required by section 83 to ignore restrictions that by their terms will never lapse. Together, Rev. Proc. 93-27 and 2001-43 adopt a practical approach to the transfer of profits interests by providing that the transfer of a profits interest within the scope of the Rev. Procs. is not a taxable event. Using liquidation value as the equivalent of fair market value for section 83 purposes for all partnership equity is consistent with partnership capital accounting, and the approach taken in the Rev. Procs., which defines a profits interest by reference to liquidation value. The Rev. Procs. do not speak to the concept of fair market value more generally, however, and they do not state that liquidation value is the same as fair market value. In 2005, the IRS and Treasury issued proposed regulations (the “2005 Proposed Regulations”) concerning the treatment of compensatory transfer of partnership interests under which the ability to value a profits interest at its liquidation value of zero would apply only under certain circumstances. These regulations have not been finalized, and they are not on the current priority guidance plan (and have not been on recent plans). Commentators to these proposed regulations raised issues regarding use of a valuation other than liquidation value.

There are several arguments in support of the use of liquidation value for private partnerships. First, the use of a value other than liquidation value is not consistent with the principles of subchapter K. It is not clear how fair market value and liquidation value might compare for a particular partnership, but having an individual include in compensation a value different than liquidation value at contribution doesn’t fit well with partnership accounting. This can be seen by comparing a transfer of a partnership interest to a payment of a bonus, followed by an after-tax contribution to the partnership. For example, if an employee were paid a bonus that, on an after-tax basis, resulted in $100 dollars of compensation and the employee then contributed that amount to a partnership, he or she would have a $100 capital account. Hence, if the partnership were liquidated that same day, he or she would be entitled to a distribution of $100. If the person were transferred that same resulting capital account balance directly, it seems appropriate to measure the transfer of value in the same way, so that the person includes the $100 in income, pays tax on that amount, and is in the same position as the person who received cash first.

Support for liquidation value for private partnerships can also be found in the section 83 regulations. Treas. Reg. section 1.83-5 provides that when property is subject to a nonlapse restriction, the price determined applying the restriction is considered the fair market value. This treatment is in contrast to lapse restrictions, including conditions that create a substantial risk of forfeiture, and must be disregarded for purposes of determining fair market value. Although the regulations provide that “in the case of property subject to a nonlapse restriction (as defined in § 1.83-3(h)), the price determined under the formula price will be considered to be the fair market value of the property unless established to the contrary by the Commissioner, and the burden of proof shall be on the commissioner with respect to such value,” it is difficult to see what basis there could be to challenge the use of liquidation value. If a partnership agreement provides that partners are bought out on the basis of their capital accounts, that method of valuation constitutes a nonlapse restriction and can be considered the method for determining fair market value under section 83.

For a publicly traded partnership, market transactions determine the fair market value. If a private partnership becomes publicly traded, the method of determining fair market value would shift to one based on market transactions. Section 83 addresses the treatment of a cancellation of a nonlapse restriction, providing that the resulting increase in value of the property is treated as compensation, unless the taxpayer establishes that the cancellation is not compensatory and that the person who would otherwise be allocated a deduction treats the cancellation as noncompensatory. The regulations expand on this concept, specifically providing that the fact that the purpose of a restriction no longer exists can support treating the lapse as noncompensatory. The most common example is an IPO:

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19 Treas. Reg. 1.83-3(h).

20 I.R.C. § 83(d)(2).
public market for the stock, use of a formula-based price likely no longer exists.21 Consistent with this rationale, the section 409A regulations limit the use of the nonlapse restriction to a private company. Once there is a public market for the stock, an option or appreciation right will satisfy the section 409A exception only if the exercise price is determined by reference to its trading price.

A profits interest provides the same right to equity appreciation as an option over corporate stock with an exercise price equal to fair market value at grant. Given those economics, a valuation model similar to that used for options could be used to set the value of a profits interest, and in fact, option-based valuation models are used for accounting purposes to set the compensation expense associated with the grant of a profits interest. Again, though, use of an option valuation method for a profits interest doesn’t fit well with the existing regime of partnership accounting. If an individual included compensation income at the time of transfer, he or she would get basis for that amount but at the same time would have a capital account balance of zero to reflect the terms of the profits interest. The 2005 Proposed Regulations would have limited the use of liquidation value for a profits interest, and the difficulties in reconciling the economic terms of the profits interest, the use of an option valuation as fair market value, and the principles of partnership accounting were raised by commentators.22

D. Section 83(b) Elections

If a capital interest is transferred subject to vesting, the service provider can make an election under section 83(b) to include the value of the interest in compensation income at transfer rather than at vesting.23 The Rev. Procs. do not provide a technical explanation for why a section 83(b) election is not required on the transfer of an unvested profits interest. The 2005 Proposed Regulations would have taken a different approach by requiring section 83(b) elections to be filed (on the theory that all partnership interests—including profits interests—constitute property for tax purposes). In practice, however, section 83(b) elections are often filed with respect to unvested profits interests, for several reasons. First, if for some reason an interest that was thought to be within the safe harbor articulated by the Rev. Procs. was not, the likely result is that the interest would be subject to section 83. This is certainly the case if the reason the interest fell outside the scope of the Rev. Procs. is because the interest was in fact a capital interest. But other issues could arise as well, for example, the holder could dispose of the interest within two years of the initial transfer.

If the interest were disposed of within two years of the initial transfer and the safe harbor of the Rev. Procs. therefore is not applicable, it is not clear what happens. Simply applying section 83, the holder would realize compensation income at vesting equal to the fair market value of the interest at that point in excess of the amount paid, if any. Vesting may have occurred prior to the disposition, even in a year prior, but it is not clear if income would be measured at that point, or at the time the Rev. Proc. became inapplicable and, if at that later point, at what value. Further, during the period the interest was unvested, any distributions would have been treated as additional compensation. If the individual is not otherwise a partner, compensation would have been received in the recipient’s capacity as an employee, required to be reported on Form W-2 and subject to FICA and income tax withholding. Any allocations to the interest should have been to other partners, as an unvested interest with no section 83(b) election is not treated as outstanding. One argument that is generally made is that this provision of the Rev. Proc. is better read as a limitation on an intent or expectation of disposition within two years, rather a limitation based on whether a disposition in fact occurs. The preamble to the proposed disguised fee for services regulations, however, states that the Treasury Department and IRS have concluded that Rev. Proc. 93-27 does not apply to a situation in which one party provides services, but the profits interest is transferred to another, related entity because the recipient of the profits interest did not provide the services to the issuing partnership and “because the service provider would effectively have disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt.”24 This conclusion raises the question of whether the Rev. Proc. can generally be read as a restriction on expectations, or if the conclusion is based on the intent of the parties at issuance.

23 See Rev. Proc. 2012-29, providing sample language for a section 83(b) election.
24 80 FR 43652, 43656.
Finally, a change in the form of the equity interest to corporate stock prior to vesting may result in compensation income at vesting. For example, assume that as part of an initial public offering, a partnership converts to a corporation. Among the outstanding equity are unvested grants that qualified as profits interests but now have value due to post-grant appreciation. If those equity interests are converted into stock with equivalent value, at vesting, the individual holds an interest—corporate stock—that is not addressed in the Rev. Proc. and is within the scope of section 83. If a timely section 83(b) election is made and, while the interest is still unvested, it is exchanged on a value-for-value basis for a different interest, the section 83(b) election would continue to apply. The exchange of one unvested interest for another would not allow for a new section 83(b) election to be made. If no section 83(b) election were filed and an interest that was a profits interest at grant is exchanged for unvested corporate stock, nothing in the Rev. Proc. suggests there is an exception to general rules of section 83—either with respect to section 83(b) elections or measurement of compensation at vesting.

For all of these reasons, it is common to see section 83(b) elections made at grant on interests that appear to be within the scope of the Rev. Proc. With the election in place, even if an interest were to fall outside the scope of the Rev. Proc., the issue would only be whether the zero liquidation method was appropriate at grant or if in fact there should have been a different method of valuation at that point. If the individual was not otherwise already a partner, FICA tax or withholding also would need to be determined under such other method.

E. Interests To or For The Benefit of the Partnership

The Rev. Proc. apply when a grant is “to or for the benefit” of the issuing partnership. The 2005 Proposed Regulations would have limited this to interests issued only for services directly to the issuing partnership. The concern that Treasury and the IRS were seeking to address was with arrangements such as one in which a profits interest is issued in a partnership that holds nothing but stock of a single corporation, with no services performed at the level of the holding partnership. In this fact pattern, the profits interest is providing the same value as an option over the corporation stock, but with the benefit of capital gains treatment rather than compensation income on exercise of the option. The approach suggested by the proposed regulations would have had the somewhat unusual effect of valuing equity interests with the same terms and conditions at different amounts for income tax purposes depending on the structure of the service arrangement. It also would not have fully reconciled the differences between options over corporate stock and profits interests, as a section 83(b) election cannot be made on an unvested option over corporate stock, but could have been over a profits interest, albeit with some value other than liquidation value.

A similar issue is raised in the preamble to the proposed disguised fee for services regulations. The preamble includes a statement that The Treasury Department and the IRS have determined that if profits interest is transferred not to the party providing the services, but to a related entity, the transaction is not one in which there is a transfer of an interest for the provision of services to or for the benefit of the issuing partnership in a partner capacity or in anticipation of becoming a partner, and because there is an effective disposition within two years.\(^{25}\)

F. Future Developments?

As of now, Rev. Proc. 93-27 and 2001-43 continue to govern the tax treatment of compensatory partnership interests. That may soon change, however, with the finalization of the proposed disguised payments for services regulations, issued in July 2015.

Although often referred to as the “fee waiver” regulations, the proposed regulations are not limited to situations involving private equity fund management fee waiver arrangements. The proposed regulations would apply to any disguised payment for services:

Consistent with the language of section 707(a)(2)(A), § 1.707-2(b) of the proposed regulations provides that an arrangement will be treated as a disguised payment for services if (i) a person (service provider), either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership; (ii) there is a related direct or indirect allocation and distribution to the service provider; and (iii) the performance of the services and the allocation and distribution when viewed together, are

\(^{25}\) 80 FR 43652, 43656.
The proposed regulations would provide for six factors to be taken into account in determining an arrangement provides for disguised payments for services, with the first the most significant factor and the other secondary:

1. **Significant entrepreneurial risk**

   There are five facts and circumstances that create a presumption that an arrangement lacks significant entrepreneurial risk and will be treated as a disguised payment for services unless other facts and circumstances establish the presence of significant entrepreneurial risk by clear and convincing evidence:

   - Capped allocations of partnership income if the cap is reasonably expected to apply in most years;
   - An allocation for one or more years under which the service provider’s share of income is reasonably certain;
   - An allocation of gross income;
   - An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g., if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or
   - An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

2. The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration.

3. The service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment.

4. The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity.

5. The value of the service provider’s interest in general and continuing partnership profits is small in relation to the allocation and distribution.

6. The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related under sections 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

### IV. PHANTOM EQUITY, APPRECIATION RIGHTS, AND OPTIONS

#### A. Overview

In many situations, it will not be appropriate to use actual transfers of equity interests as compensation. For example, the additional administrative issues may be too burdensome or the pool of participants too large. Use of equity as a measure of compensation is not limited to transfers of actual equity, but can instead be implemented through phantom equity, options, and equity appreciation rights. These arrangements are all contracts providing for future payments of compensation, in the form of cash.

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26 80 FR 43652, 43654.

27 80 FR 43652, 43654-57.
or property. The basic difference between phantom equity on the one hand and options or appreciation rights on the other is how the amount payable is calculated: "phantom equity" generally refers to rights under a contract arrangement that calculate the amount of compensation by reference to units of equity, while options or appreciation rights entitle the holder only to appreciation over a set value, such as fair market value at grant. There are also arrangements that are equity-based in a more general sense, such as bonus plans that are based on economic measure, increases in value or other organizational performance measures that are not tied directly to the equity value of the business. These arrangements can be set by the employer, or can be linked to elective deferrals by participants.

In short, because these are contracts, employers have a great deal of flexibility in determining the way in which compensation will be calculated. With the enactment of section 409A, however, there is less flexibility in setting when the amounts earned under these contracts will be paid.

B. Section 409A

1. Definition of Nonqualified Deferred Compensation

Section 409A applies to unfunded, nonqualified deferred compensation plans earned and vested on or after January 1, 2005. If a nonqualified deferred compensation plan fails to meet the requirements of paragraphs (2) (relating to distributions), (3) (relating to acceleration of benefits), or (4) (relating to elections), or is not operated in accordance with these requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years is includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. An additional tax of 20 percent is imposed on the amount required to be included under section 409A. In addition, if amounts are first included in income under section 409A in a year later than the year of initial vesting, the additional tax is increased based on interest at the underpayment rate plus one percent for the period between the taxable year in which the amount is first vested and the year in which the amounts are first included in income.

Section 409A(d)(1) defines the term "nonqualified deferred compensation plan" as any plan that provides for the deferral of compensation, other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. The regulations provide further guidance, and a broad definition of deferred compensation. A plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year.

The regulations then establish several exceptions to the definition of deferred compensation. Arrangements that fall within the definition of deferred compensation under the regulations must either be structured to fit within one of these exceptions or to comply with the section 409A requirements related to the timing of deferral elections and distributions.

The definition of "plan" under section 409A provides both that each individual has his or her own plan, even if a single document covers multiple participants, and that plans that are required to comply with section 409A that are of the same type, as set forth in the regulations, are aggregated into a single "plan." In other words, the documents do not define the plan, the plan is based on the covered person and the type of arrangement.

Section 409A applies in addition to generally applicable rules on timing of income for cash-basis taxpayers, most notably the rule of constructive receipt.

2. The Short-Term Deferral Exception to Section 409A

A common approach to phantom awards is to structure them to fit within the short-term deferral exception under section 409A, an exception also available to annual bonuses and long-term

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28 Treas. Reg. § 1.409A-6(a)(1).
30 Treas. Reg. § 1.409A-1(c).
incentive plans under which the amount payable is not linked to equity, as the exception is based on the timing of payment rather than the underlying economics of the amount payable.

The short-term deferral exception provides that there is no deferral of compensation if the payment is actually or constructively received no later than the 15th day of the third month (referred to as the 2 ½ month period) after the end of the year in which the service provider becomes vested in the right to receive it, even if the legally binding right arose in a prior year, and there are no plan provisions that would allow payment to be made at a later date. The “year” for this purpose may be the service provider’s or the service recipient’s taxable year, whichever ends later. The section 409A regulations also specify that inclusion of income under section 83, the economic benefit doctrine, section 402(b), or section 457(f) constitutes “payment.”

Whether an arrangement fits within the short-term deferral exception is determined when the legally binding right is created. A plan provides for deferred compensation if it is possible under its terms for payment to occur after the end of the short-term deferral period, even if it is in fact made within that period.

The short-term deferral period is determined by reference to the year in which the right to the compensation is no longer subject to a substantial risk of forfeiture. This term is defined for purposes of section 409A in a manner that is similar, but not identical to, the definition under section 83.

For purposes of section 409A, there are two types of conditions that can constitute a substantial risk of forfeiture: a requirement to provide substantial future services or a condition related to a purpose of the compensation. A performance condition must be tied to individual performance, or the performance of the entity as a whole. The risk that the value of an amount otherwise payable could go up or down is not a performance condition. So, for example, if an employee were given a right to ten phantom units, the fact that the value of those units could fluctuate, and even go to zero, is not a performance based condition. Although this definition parallels that used for purposes of sections 83 (transfers of property in connection with the performance of services) and 457(f) (unfunded deferred compensation plans of tax-exempt organizations), some notable differences exist. First, a requirement to refrain from performance of services (a “noncompete agreement”) cannot create a section 409A substantial risk of forfeiture. Second, any extension of a substantial risk of forfeiture after the beginning of the service period is not effective; the risk is considered to end in accordance with the original plan terms. Third, elective deferrals of compensation cannot be subject to a substantial risk of forfeiture unless the amount subject to the risk (other than earnings or amounts that would otherwise be paid for future compensation) is materially greater than the amount that is electively deferred.

An example of a requirement to provide substantial future services is a provision that provides for payment only if the employee continues in active employment for a set period after the date of grant. For example, assume a plan that requires three years of service for vesting. To meet the short-term deferral requirement, payment must be made no later than the end of the 2½ month period after the year in which the required three-year period ends. While the plan or grant could specify that timing (and as a leading practice should do so), if the document is silent on payment timing, it can still fit this exception if payments are in fact always made within the applicable short term deferral period.

Some arrangements provide exceptions to an active service requirement. For example, it is not uncommon for an arrangement to say that the participant will still be entitled to payment if the reason for termination of service is an involuntary termination or termination with good reason, death or disability or if there is a change in control. These types of conditions address events outside the employee’s control, or are triggered by employer action that prevents the employee from continuing to provide services, and so are not inconsistent with a continuing requirement to provide substantial services, because the employee cannot voluntarily quit and retain the right to the payment. As long as the arrangement makes distributions within the 2½ month period after the terminating event occurs, the arrangement continues to fit the short-term deferral exception.

The section 409A regulations include guidance on involuntary termination and what constitutes a sufficient “good reason” to be equivalent to an involuntary termination. In general, an

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33 Treas. Reg. § 1.409A-1(d).
34 Treas. Reg. § 1.409A-1(n).
involuntary separation from service results from the unilateral decision of the service recipient to terminate the service arrangement with the service provider when the service provider is otherwise willing and able to continue providing services. Whether a separation from service is involuntary is based on the facts and circumstances. A termination at the request of the service provider is voluntary. On the other hand, a resignation tendered under the threat of dismissal is not voluntary. The regulations further provide that the characterization by the parties is presumed correct, but is not determinative.

A service recipient is permitted to treat certain terminations for good reason as involuntary. The regulations include general provisions and a safe harbor. Generally, a good-reason termination is treated as an involuntary separation from service when the termination is based on the occurrence of bona fide conditions that are functionally equivalent to an involuntary separation. The conditions must require action by the service recipient resulting in a material negative to the service provider, such as duties to be performed, compensation, or the conditions under which duties are performed. Other factors include whether the service provider is required to give notice of the unfavorable conditions and provide the service recipient with a period in which to cure the violation. Another relevant factor is whether the compensation on a good-reason termination is the same as the compensation on an involuntary separation from service. A good-reason termination clause cannot be used as a way to avoid section 409A with respect to amounts that are otherwise deferred compensation payable on a voluntary separation from service.

The safe harbor under the regulations lists several specific conditions that will be treated as a bona fide basis for a good-reason termination. These conditions are:

- A material diminution in base compensation;
- A material diminution in authority, duties, or responsibilities;
- A material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider reports, including a requirement to report to an officer or other employee, rather than directly to the board of directors (or similar governing body);
- A material diminution in the budget over which the service provider retains authority;
- A material change in the geographic location at which the service provider must perform the services; and
- Any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services.

The safe harbor requires that the termination occur within the two-year period following the initial occurrence of one or more of these conditions. The amount, time, and form of payment on a good-reason termination must be substantially identical to those applicable to an involuntary separation from service, to the extent such a right exists.

Finally, the safe harbor includes specific requirements with respect to notice and cure: the service provider must be required to give notice no more than 90 days after the conditions providing a basis for a good-reason condition first exits, and must allow the service provider no less than 30 days in which to cure the violation. There is also a provision specific to collectively bargained arrangements that requires separation from service from all service recipients. In this situation, any reasonable definition of involuntary separation from service consistently used that was the subject of arm’s-length negotiations is acceptable.

Other conditions, however, do not constitute a substantial requirement to provide future services. One example is a “good reason” clause that is outside the scope of the regulations, such as a clause that gives the employee the right to terminate at any time with full vesting within a certain period after a change in control. Because the individual would have the ability to voluntarily quit with full vesting once a change in control occurred, the payments are treated as vested for section 409A purposes. Accordingly, unless payment is required to be made within 2½ months of the change in control, the agreement is no longer within the scope of the short-term deferral exception and the agreement would need to be structured to comply with section 409A.

Another example is a provision that allows for full vesting on retirement. Once a person has met the conditions for retirement, he or she can quit and retain the right to the award. As a result, the short-term deferral period would run from the date of eligibility to retire, not actual retirement,
and the grant is unlikely to fit within the exception. Accordingly, an alternative approach to compliance for those who are, or may become, eligible to retire during the period will likely be necessary.

In the examples discussed so far, the condition on payment related to the provision of substantial services. Many arrangements, however, also condition payment on a performance-based condition. For example, if an arrangement requires a participant to be actively employed at the end of the three-year period at which time a performance-based condition had to be satisfied, two separate conditions exist and and the short-term deferral period would run after both are met. In this case, if those who involuntarily terminate or are free to retire without forfeiture are nonetheless entitled to payment only to the extent the performance condition is met at the end of the three years, the award fits under the short-term deferral exception. This is the case without regard to whether the full award is payable or only a pro rata piece based on the period of services provided: either way, no amount is payable unless the performance condition is met at the end of the three-year period.

3. Compliance with Section 409A
   a. Overview

      If an exception to section 409A is not available, an arrangement must comply with section 409A with respect to timing of initial elections and distributions. In addition, the incorporation of elective deferrals of amounts that are not otherwise subject to section 409A into a plan that is required to comply with section 409A must satisfy the election timing rules. For example, an elective deferral of salary or an annual bonus is required to comply with the section 409A election timing rules, even though both the salary and bonus fit an exception to section 409A.

      The general rule for setting the time and form of payment, including elective deferral elections, provides that these decisions must be made no later than the end of the calendar year before the year in which the related service are provided. Decisions with respect to the timing of payment made by a service recipient (i.e., nonelective plan), however, are required to be made no later than the date as of which a service provider has a legally binding right to the payment or, if later, the date as of which a service provider election would be required to be made.

      The election timing provisions of the regulations reflect a more general principle—that a service provider and service recipient have the ability to negotiate the terms of any compensation arrangement until there is a legally binding right to the amount. However, this overall ability to negotiate does not allow for changes once there is a legally binding right in a manner that would not comply with section 409A. This principle is particularly important to keep in mind in the context of separation agreements, where there may be both additional amounts and amounts in satisfaction of pre-existing legally binding rights, vested or unvested, under negotiation.

      A service provider election may be required before there is a legally binding right to the payment. For example, with a discretionary bonus, there may be no legally binding right until the bonus is declared. If the service provider can elect whether to defer a portion of this bonus, however, that election must be made based on application of the election rules relative to the service period to which the bonus relates. Elections may include conditions to address this uncertainty. For example, a plan could permit an employee to elect to defer a set percentage or the portion in excess of a set dollar amount, or the plan could apply a different formula, as long as it is objective and does not allow for exercise of discretion. Additional election timing rules are addressed in the Appendix.

? occurrence of one of a limited number of events, requires that the distribution events be specified in advance, and restricts the acceleration of distributions.

There are six permitted section 409A distribution events (described in more detail below):

- Separation from service (provided that a “specified employee” of a public company may not receive distributions until at least six months after separation);
- A fixed time, or pursuant to a fixed schedule, specified under the plan;
- Death;
- Disability;
- Change in control of a corporation (change in control of a partnership is subject to analogous rules); and
- Unforeseeable emergency.37

Each of these terms has specific definitions, addressed further in the Appendix. A plan may provide that payments will be made on the earlier or later of several distribution events. Distributions do not have to be made precisely on a scheduled day. A payment is treated as timely if it is made after the scheduled date but in the same calendar year or, if later, by the 15th day of the third calendar month following the scheduled date. The final regulations also provide that an early payment is timely if made no more than 30 days before the scheduled date. Where a plan states that a payment will be made within a specified period (e.g., within 90 days after a particular date), the first day of that period is the “scheduled date” for purposes of the timing rules. The period must either begin and end in the same taxable year or be no longer than 90 days. If it is possible for a distribution to be made in either of two years, the service provider may not have the ability to designate, directly or indirectly, the year in which a payment will be made. Payment with respect to a stock right occurs on the exercise date.

A distribution does not have to be made immediately on a distribution event; rather, the time of the distribution may be fixed by reference to the event (e.g., six months after separation from service, or three years after death). It is also permissible to base the time of payment on a vesting date.

With two exceptions, a plan may only designate a single time and form of payment with respect to each distribution event. First, for distributions other than at a fixed time or on account of a separation from service, different methods of distribution may be specified for events occurring before or after a fixed or determinable date. For example, a distribution on account of a change of control might be made in a lump sum before age 55 and in the form of a life annuity afterward. Second, a plan may have different distribution methods for separations from service that occur (1) within two years after a change of control or (2) before or after a stated date, a stated age, or attainment of a stated combination of age and service. An example of permissible payment alternatives would be payment in a lump sum upon change of control, payment in five annual installments following separation from service before age 65, or payment as a life annuity following separation after age 65.

Earnings (including dividend equivalents) under a plan may have a different distribution schedule from deferrals. However, the schedule must be specified at the same time as the schedule for distributing deferrals, and earnings must be calculated at least annually.

c. Changes in Time and Form of Distribution

The date on which distributions will commence may be postponed (whether the postponement is at the election of the service provider or the service recipient) if the following conditions are met:38

- The election to delay must be made not less than 12 months before a scheduled payment.

38 Treas. Reg. § 1.409A-2(b).
The election may be effective no earlier than 12 months after it is made. If a distribution event occurs in the interim, the original distribution method must be followed.

- The postponement must be for at least an additional five years. Distributions on account of death, disability, or unforeseeable emergency may be postponed for shorter periods.

Postponement elections apply to each distribution event separately. For instance, if the plan makes distributions upon the earlier of separation from service or attainment of age 65, then the fixed date could be changed to age 70 without affecting the timing of the distribution if the participant separates from service.

Compliance with the preceding conditions is evaluated on a payment-by-payment basis. What constitutes a "payment" depends on the terms of the plan. If a distribution is to be made in the form of a series of installment payments, the plan may treat the entire series as a single payment, commencing on the date of the first installment, or each installment as a separate payment. The latter approach allows postponement of the receipt of particular installments without the need to delay the entire series. If the installments are designated as a single payment, individual installments may not be postponed. On the other hand, the entire series may be converted into a lump sum, payable no earlier than five years after the initial installment was originally due.

Where a distribution is to be made in annuity form (that is, where the length of the distribution period depends, in whole or in part, upon one or more lives), individual payments may not be postponed separately. Because the annuity is a single payment, it also may be converted into a lump sum payable no earlier than five years after the annuity starting date.

The preceding rules also apply to distributions initially designated as short-term deferrals not subject to section 409A. An election to postpone distribution beyond the 2½ months period after the end of the year in which vesting occurs must comply with either the initial deferral rules or the postponement rules.

The same rules apply to plan amendments that have the effect of changing the timing of distributions. For example, an amendment to change the definition of "separation from service" under a plan must be implemented as if it were an election to postpone distributions.

C. Phantom Equity and Bonus Plans

Nonqualified deferred compensation denominated in employer equity provides a contractual right to a transfer of a certain number of equity units, or payment in an amount equal to the value of the equity, at a future time. These arrangements are often referred to in the corporate context as restricted stock units, phantom units, or, if vesting is tied to performance goals, performance units. These arrangements can provide for payment at the time of vesting or they can provide for further deferral of compensation beyond vesting, subject to compliance with section 409A. The same sorts of arrangements are available in the context of a partnership.

For both corporations and partnerships, the basic challenge is to fit the economic arrangement between the parties into an exception to section 409A or to comply with its requirements. Phantom equity units that pay after satisfaction of service conditions, performance goals, or both, will generally fit within the short-term deferral exception. To the extent that an employer is willing to allow elective deferrals, it is common for a plan to allow deferred amounts to be distributed on the earlier of a combination of separation from service, after a fixed period has elapsed, death, disability, or change in control. Payments may be available in a set number of installments or a lump sum. Once the time and form of a distribution is set, the rules outlined above for a rededeferral apply.

In some cases, an employer may require post-vesting deferral. For example, a plan could provide that the amount of a bonus is earned after certain service and performance conditions are met, but with only a set percentage, e.g., 50% payable after vesting. The rest would be required to be deferred and paid after a set period, perhaps one or two years. During that period, the amount may be subject to a risk of loss that does not rise to a substantial risk of forfeiture for section 409A, such as a claw back condition or a noncompete. Because the payments, if any, will be made on a permissible section 409A distribution event, this basic design complies with section 409A.

Not all economic arrangements fit as easily into section 409A, however. Compliance with section 409A is particularly difficult for many businesses that commonly operate as partnerships, such as private equity or venture capital investors, or real estate developers. For example, many events that may have economic significance are not permissible section 409A distribution events, and therefore
a plan cannot simply provide for these events to be distribution triggers for amounts no longer subject to a substantial risk of forfeiture. Examples of these non-distribution events include an IPO and any of the following events, unless the transaction also qualifies as a section 409A “change in control”: the sale of a specific investment or other realization event or the sale of equity by a shareholder or sponsor that does not qualify as a change in control.

A common pre-section 409A arrangement affected by these restrictions is a so-called “phantom carry,” a compensation arrangement that provides for payments by reference to the timing of allocations to partners in an identified partnership. The challenge with fitting such an arrangement into compliance with section 409A is that the allocation of income to a partner is not a section 409A distribution event, and the sale of a specific asset or other event that results in the allocation itself also may not a permissible distribution event. For example, in the context of a private equity fund, the sale of a portfolio company could be a realization event that results in the allocation of income and distributions. Even if that sale is a change in control under section 409A in general, it is a distribution event only for services providers to the company sold. Therefore, it is necessary to try to find an approach to compliance with section 409A that fits mostly closely with the intended arrangement between the parties.

There are several approaches that may be taken to try to reconcile this economic arrangement with section 409A. One is to impose a continuing service condition: if a plan says that it provides for payments based on allocations to partners, provided the service provider is actively providing services when the allocation is made, the arrangement can fit within the short-term deferral exception. In some circumstances, however, this may be a significant change to the arrangement. For example, in the real estate industry, it may be many years after a project is developed before all income related to that project is realized, but the critical services required to earn the compensation may be provided only in the first few years. An ongoing service condition is inconsistent with the desire to provide equity-based compensation to the service provider, based on amounts actually realized.

Another approach that is also based on the short-term deferral exception is one that requires satisfaction of a performance-based substantial risk of forfeiture. For example, a plan may provide for compensation linked to allocations, including payments to former employees, but only if an additional condition is met, such as achievement of a level of profits in the year of the allocation, a requirement that any realization event that triggers an allocation meet a specific rate of return or appreciation requirement, or other conditions that constitute an ongoing substantial risk of forfeiture. A difficulty with this approach is that the condition must be one that continues to be unmet through the life of the plan. For example, a condition that says no payments will be met until capital investors receive a return on their investment of a certain amount could be met early in the life of a fund, before a time when all payments that have been agreed to under the compensation plan will be made within the short-term deferral period.

An additional challenge with performance-based vesting conditions relates to whether the condition is in fact a vesting condition or simply a condition on timing of payment (and which is not a permissible section 409A distribution event). For example, the regulations state that “the occurrence of an IPO” is a performance-based condition. If the condition is broadened to include other types of exits or sales transactions, however, it raises the question of whether there is an actual “condition” on payment—particularly if a sale or exit event is likely under the facts and circumstances. In this case, a condition may be strengthened by adding a time component, that the exit event not only has to occur but it must occur within three or five years of grant, or twelve or twenty-four months after an involuntary termination of employment. Another alternative is to impose an additional condition related to the value at exit, e.g., an exit event in which valuation, as determined by a third-party offer to purchase, is not less than a set level.

A third approach that may be appropriate under some circumstances is to implement a plan based on the provision in the regulations that allows a compliant payment schedule determined by timing of payments received by the service recipient. The regulations impose conditions on the ability to use these schedules that may render this approach impractical. First, this provision does not apply to payments from one entity to another if the two entities are a single “service recipient.” Second, to comply with this exception, the following conditions must be met:

The payments due to the service recipient arise from bona fide and routine transactions in the ordinary course of business of the service recipient.

The service provider does not have effective control of the service recipient, the person from whom such amounts are due, or the collection of any of the amounts due to the service recipient.

The payment schedule provides an objective, nondiscretionary method of identification of the payments to the service recipient from which the amount of the payment from the service recipient to the service provider is determined.

The payment schedule provides an objective, nondiscretionary schedule under which the payments will be made to the service provider.

The payments to the service recipient from which the amount of the payments from service recipient to the service provider are determined result from sales of a type that the service recipient is in the trade or business of making and makes frequently, and either all such sales by the service recipient are taken into account for purposes of determining the payment to the service provider, or there is a legitimate, non-tax business reason for identifying the specific sales taken into account.

The challenge in determining if this provision is available is often in determining whether the service provider has effective control over the timing of payment, for example, through an ability to control the timing of realization events that result in allocations.

D. Options and Appreciation Rights

A second category of arrangements includes options and appreciation rights. While both provide for a right to share in equity appreciation over a set equity value, or exercise price, the term "option" generally refers to a grant that allows the holder to pay the stated exercise price and receive transfer of the option property. However, the grant may also allow for net settlement (transfer of equity or cash equal to the difference between the fair market value of the option property at exercise over the exercise price, i.e., the intrinsic value or option spread). Appreciation rights, on the other hand, generally entitle the holder only to a transfer of cash or equity equal to the spread. In general, both an option and an appreciation right fit the definition of deferred compensation because both provide a service provider with a legally binding right in one year to an amount of compensation, based on the excess of the fair market value of the stock at the time of exercise over the exercise price, payable in a future year.

Section 83 governs the transfer of any property in connection with the performance of services. The grant of an option to purchase property does not constitute a transfer of property. If an employee is granted an option to purchase property, section 83(a) applies to the grant of the option only if the option has a readily ascertainable fair market value at the time the option is granted. Whether or not an option has a readily ascertainable fair market value is determined at the time the option is granted. Generally, stock options granted to employees do not have a readily ascertainable fair market value at the time they are granted. If section 83(a) does not apply to the grant of a stock option to an employee, section 83(a) applies at the time the stock option is exercised or otherwise disposed of. If the stock option is sold or otherwise disposed of in an arm's length transaction, section 83(a) applies to the transfer of money or other property received in the same manner as section 83(a) would have applied to the transfer of property pursuant to an exercise of the option.

Appreciation rights may not be subject to section 83. If settled in cash, there is no property transfer involved, and the arrangement represents a mere contractual right to compensation with the realization of the compensation income being determined under the general principles of actual or constructive receipt. It is not clear whether an appreciation right that settles in property is subject to section 83 or is analyzed as deferred compensation. From the perspective of the service provider, the results are the same.

43 There is a potential deduction timing issue, depending on whether I.R.C. § 83, and therefore Treas. Reg. 1.83-6(a)(3) applies to the transfer of stock on exercise of an appreciation right, or if the deduction is determined under section 404(a)(5). See SAR ruling.
Because an option or appreciation grant provides a right to appreciation in equity value just as a profits interest does, options or appreciation rights may be appropriate as a way of providing equity-based compensation without making an individual a partner. Options and appreciation rights have the advantage that they can provide for deferral beyond vesting and can allow the participant to determine when to exercise. Alternatively, the windows for exercise can be restricted to certain events.

Options and appreciation rights fit the broad definition of deferred compensation under section 409A, as they provide for a legally binding right in one year to compensation that may be payable in a subsequent year. There is an exception to section 409A for compensatory options and appreciation rights that applies to awards that comply with the following requirements:

- The options or appreciation rights are granted over “service recipient stock”;
- The exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in Treas. Reg. section 1.83-3(i)) on the date the option is granted and the number of shares subject to the option is fixed on the original date of grant of the option;
- The transfer or exercise of the option is subject to taxation under section 83 and Treas. Reg. section 1.83-7; and
- The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the following:
  - The exercise or disposition of the option under Treas. Reg. section 1.83-7; or
  - The time the stock acquired pursuant to the exercise of the option first becomes substantially vested (as defined in Treas. Reg. section 1.83-3(b)).

Although the regulations only discuss stock, the preamble to the proposed section 409A regulations indicated that the concepts in the regulations apply by analogy to partnership interests. Further discussion of the requirements of this exception can be found in the Appendix.

In applying the stock option and appreciation right exceptions by analogy, there are several key points. One issue is determining what equity interests can qualify as “service recipient stock.” The section 409A regulations provide that an eligible issuer of service recipient stock is “only the corporation for which the service provider provides direct services on the date of grant of the stock right (if the entity receiving such services is a corporation), and any corporation in a chain of corporations or other entities in which each corporation or other entity has a controlling interest in another corporation or other entity in the chain, ending with the corporation or other entity that has a controlling interest in the corporation or other entity for which the service provider provides direct services on the date of grant of the stock right.”

Service recipient stock is defined generally as “a class of stock that, as of the date of grant, is common stock for purposes of section 305 and the regulations thereunder of a corporation that is an eligible issuer of service recipient stock.” Service recipient stock does not include a class of stock that has any preference as to distributions other than distributions of service recipient stock and distributions in liquidation of the issuer or “any stock that is subject to a mandatory repurchase obligation (other than a right of first refusal), or a put or call right that is not a lapse restriction as defined in § 1.83-3(i), if the stock price under such right or obligation is based on a measure other than the fair market value (disregarding lapse restrictions as defined in § 1.83-3(i)) of the equity interest in the corporation represented by the stock.”

Applying this definition by analogy to partnership equity interests, the equivalent of “common stock” would be interests that do not have a right to priority allocations over any other class of equity. Somewhat more confusing is what it means for there to be no preference as to distributions. In a

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44 Treas. Reg. § 1.409A-1(b)(5).
45 72 Fed. Reg. 19234, § II.E.
48 See Prop Treas. Reg. § 1.409A-1(b)(5)(iii)(A), clarifying this provision.
corporate entity, preferred dividends are a way that a class of equity would have senior rights over another class of equity. In a partnership, however, the analogy would be a priority right to allocations of distributive share. In contrast, a tax distribution is not an additional right to value, but a distribution to satisfy tax obligations. It doesn’t seem that tax distributions are analogous to a “preference over distributions” that would disqualify a class of equity as eligible for options or appreciation rights.

Another issue related to distributions involves the restriction on treatment of dividends. The regulations provide that a right to receive dividends or other distributions that is conditioned on the exercise of an option is an offset to the exercise price of the stock option or an increase in the amount payable under the stock appreciation right. Instead, dividend equivalent rights must be paid in a way that either fits within the short-term deferral exception, or complies with section 409A. In contrast, it is permissible to adjust the exercise price of an option to reflect distributions other than ordinary dividends to the extent they fit the definition of “corporate transaction.” Here again, the question is how to analogize this provision in the partnership context. For example, a tax distribution is not analogous to a dividend, but it does not fit within the definition of “corporate transaction.” The value of a unit, reduced by distributions to cover tax liabilities, does, however, seem to be a better measure of the equity appreciation of the partnership. As a result, many options or appreciation right plans over partnership equity do not make adjustments for tax distributions. If such an adjustment were made, or amounts distributed to cover taxes were credited and paid to an individual who exercises an option or appreciation right, that additional distribution right should be structured to comply with section 409A, as a short-term deferral or complaint arrangement, and not conditioned on the exercise of the option or appreciation right.

Finally, there is the question of valuation – how to set the exercise price. As discussed above in section III.C, the use of liquidation value as fair market value for interest in a private partnership is consistent with subchapter K principles, the economics of the transfer, and the concept of a nonlapse restriction under the section 83 regulations. In addition, an at-the-money option or appreciation right provides the same right to equity appreciation as a profits interest, which is defined by reference to liquidation value under Rev. Proc. 93-27. There are three small harbor provisions for valuing private company equity, one of which applies to a formula-based valuation that would constitute a nonlapse restriction for purposes of section 83, provided it is used both for compensatory transactions and in connection with transfers to the issuer or a 10 percent shareholder. For these reasons, using liquidation value is the proper analogy to the requirement under the section 409A regulations that the exercise price of an option or appreciation right cannot be less than fair market value at grant.

An arrangement that provides for compensation based on appreciation in equity rights but does not meet the exception for options or appreciation rights must comply with section 409A based on the same principles in section IV(3). above.

V. SECTION 409A AND PARTNER COMPENSATION

A. Transfers of Property

A transfer of a partnership interest are not subject to section 409A: there is an exception to the definition of deferred compensation for transfers of restricted property. 49 The final regulations provide that grants of profits and other partnership interests are governed by the provisions applicable to stock rights. 50

B. Partnership Income

Most arrangements with a partner fall outside the scope of section 409A, such as payments to retiring partners in liquidation of their partnership interests, other than to the extent a partner claims the benefit of the SECA exclusion for retirement payments in section 1402(a)(1). For these amounts, until further guidance is issued, a retiring partner may establish the time and form of payment of amounts exempt from self-employment taxes under section 1402(a)(10) at any time before the last day of the tax year preceding the tax year in which such payment will be made. For example, if a partner wants to retire from the partnership and begin receiving payments at age 58 in a form that will be exempt from employment tax under section 1402(a)(10), he needs to make an election by the end of the year in which he turns 57.

50 72 Fed. Reg. 19234, § III.G.
Guaranteed payments described in section 707(c), other than payments in liquidation of a partnership interest, are subject to section 409A if attributable to the performance of services and not included in the partner’s income by the 15th day of the third month following the end of the tax year in which he first had a vested, legally binding right to the payment. Finally, payments to a partner in other than in a partnership capacity are subject to section 409A if they otherwise constitute nonqualified deferred compensation.

VI. **SECTION 457A**

Section 457A provides that compensation deferred under a nonqualified plan of a nonqualified entity is includible in gross income when there is no substantial risk of forfeiture of the rights to such compensation (i.e., upon vesting). If the amount is not determinable upon vesting, then it is not includible until it becomes determinable. However, an additional 20% tax and an interest penalty tax will apply. Thus, while section 409A regulates deferred compensation, section 457A restricts the ability of service providers performing services for certain nonqualified service recipients to defer compensation at all. The model for section 457A is section 457(f), which similarly precludes deferral of compensation for services to certain tax-exempt service recipients. Guidance on section 457A was provided in Notice 2009-8.51

Section 457A applies to amounts deferred attributable to services performed after December 31, 2008. In addition, deferred amounts that are attributable to services performed prior to 2009 that are not included in income in a taxable year beginning before 2018 are includible in income in the later of the last taxable year beginning before January 1, 2018, or the first taxable year in which there is no substantial risk of forfeiture.

Section 457A applies only if the plan sponsor is a nonqualified entity. The sponsor is the entity which, if it paid the deferred amount to the service provider in cash in the relevant taxable year, would be entitled to a compensation deduction under U.S. federal income tax principles. A nonqualified entity can be either a corporation or a partnership for U.S. tax purposes. Section 457A applies to any foreign corporation unless substantially all of its income is:

- Effectively connected with the conduct of a trade or business in the United States (US ECI), or
- Subject to a comprehensive foreign income tax.

A foreign corporation is a corporation as defined in section 7701(a)(3) that is not domestic as defined in section 7701(a)(4).

To be considered subject to a comprehensive foreign income tax, the corporation must either be eligible for the benefits of a comprehensive income tax treaty between its country of residence and the United States, or demonstrate that it is resident in a foreign country that has a comprehensive income tax. Finally, the corporation must not be taxed under a regime that is materially more favorable than the corporate income tax generally imposed by the foreign country.

Furthermore, even if the corporation is subject to a comprehensive income tax, no more than 20% of its income can be “excluded income.” Excluded income is nonresidence income that is not included in taxable income or is subject to a rate of tax less than fifty percent of the general rate, but not including either U.S. ECI or dividends of a U.S. corporation or a corporation substantially all of the income of which is subject to a comprehensive foreign income tax.

A partnership is a nonqualified entity unless substantially all of its income is allocated to persons other than:

- Foreign persons with respect to whom such income is not subject to tax (U.S. or, to some extent, foreign), or
- Organizations exempt from tax under the Code.

“Partnership” has the meaning given in section 7701(a)(2). 80% or more of income must be allocated to “eligible persons,” as defined in the Notice 2009-8. Income is allocated to an eligible person to the extent it is

51 2009-1 C.B. 347.
- U.S. ECI,
- Unrelated business taxable income,
- Allocated to a U.S. taxpayer, with limited exceptions, or
- Allocated to a foreign taxpayer subject to comprehensive foreign income tax

The determination of whether an entity is nonqualified is made as of the last day of each of the service provider's taxable years in which the deferred compensation is no longer subject to a substantial risk of forfeiture. For partnerships, this determination is based on the allocations (or deemed allocations) of gross income by the partnership for the partnership's taxable year ending with or within the service provider's taxable year.

The definition of deferred compensation for purposes of section 457A is generally the same as that applicable under section 409A, except that for section 457A, deferred compensation includes "rights to compensation based on the appreciation in value of a specified number of equity units of the service recipient," other than stock options and appreciation rights settled in service recipient stock—a more narrow exception than applicable under section 409A.

The definition of substantial risk of forfeiture under section 457A is also more limited, and provides that rights to compensation are subject to a substantial risk of forfeiture only to the extent the rights are conditioned upon the future performance of substantial services by the person. The following conditions are not substantial risks of forfeiture for purposes of section 457A:

- Conditions related to a purpose of the compensation (e.g., performance vesting);
- Refraining from the performance of services (e.g., a covenant not to compete);
- Extensions during the vesting period; or
- A risk of forfeiture applied to amounts that could have been received in cash, unless payment in subsequent year is materially greater than the present value that could be received otherwise.

The short-term deferral exception under section 457A also differs from that under section 409A. For section 457A purposes, a short-term deferral is compensation paid not later than 12 months after the end of the service recipient's taxable year during which the right to payment is first no longer subject to a substantial risk of forfeiture, as defined in section 457A.

Section 457A applies to both cash and accrual basis taxpayers, including individuals, C corporations and S corporations, partnerships, personal service corporations/entities that would be personal service corporations if they were corporations, and qualified personal service corporations/entities that would be qualified personal service corporation if they were corporations. Section 457A does not apply to independent contractors excluded from coverage under section 409A or arrangements between a partner and a partnership excluded under section 409A.

Sections 457A and 409A may both apply to amounts deferred under an arrangement that constitutes deferred compensation for purposes of both sections. Inclusion in income under section 457A is treated as a payment for purposes of the short-term deferral rule under section 409A and, pending further guidance, the inclusion of earnings in income under section 457A will generally be treated as section 409A compliant.
VII. APPENDIX: SELECTED ISSUES UNDER SECTION 409A

Overview

Section 409A applies to unfunded, nonqualified deferred compensation plans earned and vested on or after January 1, 2005. The following sections provide additional background on some of the concepts under section 409A and the regulations addressed in the discussion above. If the requirements of section 409A(a)(1) are not met, all compensation deferred under the plan for the taxable year and all preceding taxable years is includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. An additional tax of 20 percent is imposed on the amount required to be included under section 409A, increased in some circumstances by an additional tax based on interest at the underpayment rate plus one percent for the period between the taxable year in which the amount is first vested and the year in which the amounts are first included in income.

Definition of Nonqualified Deferred Compensation

A “nonqualified deferred compensation plan” is any plan that provides for the deferral of compensation, other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. Treas. Reg. § 1.409A-1 (b)(1).

Key Exceptions to “Deferred Compensation”

Short term deferrals

This exception, discussed in the main outline in section IV.B.2, applies to arrangements under which payments will be made no later than the applicable 2½ month period after the year of vesting. This exception applies to a payment only if the plan does not provide that any part of that payment will be paid beyond the end of the short-term deferral period. In contrast, the ability to elect a deferred payment date under an arrangement will not automatically exclude it from meeting the short-term deferral exception, so long as no election or failure to elect can postpone the payment beyond two-and-a-half months after year-end, or allow for the payment in either of two taxable years. For example, if a bonus plan fits within short-term deferral, the fact that participants can elect to defer some or all of the bonus payment under an arrangement that does constitute nonqualified deferred compensation does not mean the bonus arrangement is also deferred compensation. If a plan provides for more than one payment, but they are specified as separate payments (rather than a single series of installments), the fact that later, separately identified payments will be made beyond the permissible short-term deferral period does not affect the treatment of the earlier payments. The exception is not available, however, for annuities, which are treated under the regulations as a single undifferentiated payment.

The two-and-a-half month deadline can be extended under some circumstances. First, a payment may retain its status as a short-term deferral if timely payment was administratively impracticable and the impracticability was unforeseeable. Second, a payment may be delayed if making it within the short-term deferral period would jeopardize the ability of the service recipient to continue as a going concern. In either of these cases, payment must be made as soon as the reason for delay ceases to exist. Third, a payment may be delayed if its deduction is restricted by section 162(m) and a reasonable person would not have anticipated that restriction at the time the legally binding right arose. Payment must then be made as soon as the deduction is no longer restricted by the application of section 162(m). The use of this rule could delay payment of a “short-term” deferral for many years, for example, until a newly promoted executive falls out of the group covered by section 162(m).

A short-term deferral arrangement is not required to be in writing, or to have specific terms for payment. The use of a written document with a specified payment date will almost always be advisable, however, to confirm that the exception is applicable. In addition, it may be possible to draft a short term deferral plan in a way that provides additional flexibility. The regulations make clear that a plan that merely provides for payment “before March 15” will not be able to make payments after March 15 and comply with the rules of section 409A if it was possible for payments to be made before January 1. Therefore, if it is important for the employer to retain the flexibility to make payments before or after March 15, the plan document should be carefully reviewed to confirm that payments cannot span two taxable years and that other potentially applicable section 409A requirements are satisfied.
Options and appreciation rights

In general, nondiscounted stock rights that are issued on service recipient stock and do not have an additional deferral feature are exempt from section 409A. Stock rights that do not meet these criteria may still be granted but will be considered deferred compensation and must comply with all of the applicable section 409A requirements.

There are two main criteria that an exempt stock option must satisfy. First, the exercise price may never be less than the fair market value (disregarding any risks of forfeiture or other lapse restrictions) of the optioned property on the date of grant, and the number of shares subject to the option must be fixed at that time. Second, the option cannot include any feature that defers income inclusion beyond when it would ordinarily occur under section 83 (i.e., exercise or disposition of the option or, if later, substantial vesting in the stock acquired upon exercise). This restriction effectively eliminates the technique of postponing the taxation of option exercise gains through a nonqualified deferred compensation plan.

SARs fall within the stock rights exception by meeting similar, but slightly modified, requirements. First, compensation payable under the SAR cannot be greater than the excess of the fair market value of the stock (disregarding any lapse restrictions) on the date of exercise over the fair market value on the date of grant of a fixed number of shares specified at that time. Second, the SAR may not include any feature that delays income inclusion beyond the exercise of the SAR.

Statutory stock rights, including incentive stock options (section 422) and options granted under employee stock purchase plans (section 423), are excluded regardless of whether they meet the preceding conditions. For example, a discounted option granted under an employee stock purchase plan is exempt from section 409A even though, if not subject to section 423, it would be considered deferred compensation subject to section 409A.

Service Recipient Stock

Stock rights may be granted on the stock of the direct service recipient, or of any corporation that owns a controlling interest in the service recipient or is included in a chain of organizations, each of which is controlled by another organization, ending with the parent organization. The term “controlling interest” is defined by reference to the controlled group rules applicable to qualified plans (Treasury Reg. section 1.414(c)-2(b)(i)) but with “at least 50 percent” substituted for “at least 80 percent.” Note that stock of a service recipient’s subsidiary or of a brother-sister corporation can never be “service recipient stock” under this definition.

Where there are legitimate business criteria, based on facts and circumstances, for a service recipient to grant an option to a particular service provider, the controlling interest ownership threshold is reduced to 20 percent. The regulations do not require a formal election to take advantage of the lower threshold. Instead, it may be utilized on a grant-by-grant basis so long as the “legitimate business criteria” in fact exist. The analysis focuses primarily on whether there is sufficient nexus between a particular service provider and option issuer to give the grant legitimate nontax business purposes.

A corporation whose primary purpose is to serve as an investment vehicle can grant stock rights only to its own direct service providers. Furthermore, a general anti-abuse rule has been added as an overlay: any ownership structure or transaction undertaken solely to provide deferred compensation not subject to section 409A will be disregarded in identifying service recipient stock. The final regulations specifically provide that if the primary source of revenue is the provision of management services to other members of the group, the structure will be presumed to be for the avoidance of section 409A.

Eligible common stock does not include stock with any dividend preference (though a liquidation preference is permitted) or stock subject to either a mandatory repurchase obligation (other than a right of first refusal) or a put or call right at a price other than the fair market value of the stock (though lapse restrictions as defined in Treasury Reg. section 1.83-3(i) are allowed).

American depositary receipts and American depositary shares are treated as service recipient stock if the stock to which they relate would otherwise qualify. Mutual companies (e.g., mutual insurance companies and mutual banks) can issue equity rights to employees using mutual company units. The IRS has reserved the right to issue future guidance under which interests in other types of entities may be treated as service recipient stock. For noncorporate entities, such as partnerships and LLCs, the preamble states that the rules for stock may be applied by analogy.
One of the requirements for section 409A-exempt stock rights is that the exercise price of stock options cannot be less than fair market value on the date of grant and SARs may not have any built-in gain when granted. As a result, it is important to determine fair market value accurately. For stock that is readily tradable on an established securities market, the final regulations allow the use of methods for deriving fair market value from actual transactions, including the last sale price before grant, first sale price after grant, or closing price on the trading day before or after grant, as well as an average price over a period of up to 30 days before or after grant if specified in advance. To make use of averaging, the service recipient must designate the recipient of the stock right, the number and class of shares subject to the stock right, and the method for determining the exercise price, including the period over which the price will be averaged, before the averaging period begins.

Determining fair market value is more challenging for stock that is not traded on an established market. In general, the regulations require reasonable application of a reasonable method, taking into account all relevant facts and circumstances, and factors such as the value of tangible and intangible assets, the present value of anticipated cash flows, and recent arm’s-length transactions involving the sale or transfer of the stock, to list a few. It is not reasonable to rely on a valuation that is more than 12 months old or that has been rendered obsolete by material changes of fact. If the stock becomes readily tradable on an established securities market after the stock right is granted, the stock must thereafter be valued using the methods for readily tradable stock.

The final regulations retain the three valuation safe harbors introduced in the proposed regulations, with some modifications. Use of one of these methods on a consistent basis is presumed reasonable; to rebut the presumption, the IRS must show that the valuation method or the application of the method was grossly unreasonable. The three safe harbor methods are:

- An independent appraisal that meets the requirements for valuing stock held by employee stock ownership plans and was issued no more than 12 months before the date of grant of the stock right;

- A formula-based valuation that would constitute a nonlapse restriction for purposes of section 83 and will by its terms be used so long as the stock is not publicly traded, provided that it is used both for compensatory transactions and in connection with transfers to the issuer or a 10 percent shareholder, though its use need not be required in a sale of all or substantially all of the outstanding stock; or

- For illiquid stock of start-up companies (generally, those that have been in business for less than 10 years, have no publicly traded class of securities, and do not reasonably anticipate a change in control within 90 days or a public offering within the next 180 days), a reasonable, good-faith valuation evidenced by a written report issued by someone who is qualified, but not necessarily independent.

Modifications

A modification of a stock right, except for an extension or renewal, is treated as a new grant, which is exempt from section 409A only if, at that moment, it meets the conditions for exemption (e.g., the current fair market value of the stock is at or below the exercise price). Any change in the terms of a stock right or plan that “may provide the holder of the stock right with a direct or indirect reduction in the exercise price of the stock right regardless of whether the holder in fact benefits from the change in terms” is a modification. Changes related to the timing of exercisability within the original term, the method of exercise (such as adding the right to tender previously owned shares), or tax withholding are not modifications for this purpose. A renewal or extension, unless it meets the criteria described below, is treated as the addition of a feature allowing for additional deferral, retroactive to the original date of grant. As a result, the renewed or extended stock right is treated as having violated section 409A since its date of inception.

The final regulations allow the term of a stock right to be extended in several instances. First, extensions are allowed if the extended period ends no later than the earlier of 10 years from the date of grant or the end of the maximum term for which the right could have been exercised under the terms of the plan. Thus, for example, if an option generally provides only 30 or 90 days to exercise post termination of employment, it is permissible to waive that limitation and allow the stock right to remain outstanding, up to the earlier of 10 years from grant or the end of the maximum stated term. Second, the extension of an underwater stock right is permissible without restrictions. Finally, if a stock right cannot
be exercised without violation of applicable federal, state, local, and foreign laws, or if its exercise would jeopardize the service recipient’s ability to continue as a going concern, its term can be extended until no more than 30 days after the date on which exercise is possible without adverse consequences. If an extension does not fall within one of these exceptions, then it will result in the stock grant having an additional deferral feature, and it will be treated as a noncompliant option from the date of original grant.

Substitutions and assumptions of stock rights following a corporate transaction are not treated as modifications under conditions generally similar to those that apply to incentive stock options. The principal constraint is that the aggregate spread between current fair market value and exercise price may not be increased. Unlike the rule for ISOs, it is permissible to change the ratio of the exercise price to current fair market value and substitute a stock right that is relatively more discounted than the original right, although there is no comparable ability to substitute a stock right that is relatively less discounted than the original one. Stock rights may also be proportionately adjusted to reflect a stock split or stock dividend. In connection with a spin-off or similar transaction, the regulations permit the substitution of stock rights on stock of both the distributing entity and the distributed entity, without regard to the fact that the recipient is unlikely to be a service provider with respect to both. (Both of the substituted classes of stock must satisfy all of the other requirements for service recipient stock, other than a nexus between the issuer and the service provider.)

The definition of “corporate transaction” is by reference to the ISO rules. This definition provides that a corporate transaction includes “a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation; [and] a distribution (excluding an ordinary dividend or a stock split or stock dividend . . . , or a change in the terms or number of outstanding shares of such corporation.” Stock splits and stock dividends are covered by a specific rule that allows appropriate adjustments without the application of the modified ratio and spread test. A substitution following a cash distribution is permitted if the distribution is not an “ordinary dividend.” If it is, payment to the holder of the stock right must comply with section 409A. Dividends may be paid currently or accumulated in an arrangement that satisfies either short-term deferral or the ordinary rules of section 409A. Paying accumulated dividends when a stock right is exercised is not allowed. It is treated as reducing the exercise price, which will cause the stock right to fall out of compliance with section 409A. A distribution that is not an ordinary dividend can be handled in the same way as an ordinary dividend, or the stock rights may be adjusted to reflect the effect on the fair market value of the stock. Whether a payment is an ordinary dividend is a question of general corporate tax law.

**Feature for Deferral of Income**

A stock right is subject to section 409A if it includes any additional feature for the deferral of compensation after income recognition has been triggered by exercise. The final regulations clarify that this restriction does not rule out several common features: the stock received on exercise can be nonvested (so that there is no taxation until it vests); the exercise price may be paid by the use of stock that the option holder already owns; plans may include provisions for cashless exercise; and tandem stock options/SARs plans, under which the exercise of either right cancels the other, are permitted.

**Other Definitions**

The final regulations introduce several definitions of terms necessary to determine whether the stock right exception is satisfied. The definitions of “stock,” “date of grant,” “exercise price,” “exercise,” and “transfer” are similar to those in the ISO regulations. Thus, for example, the term “date of grant” is defined as the date on which the granting corporation completes the corporate action necessary to create a legally binding right to the stock right. This action is not considered complete until the maximum number of shares, the exercise price, the class of stock, and the identity of the recipient are designated. The defined terms incorporate a number of definitions from the ISO regulations and, presumably, will be applied in a similar fashion.

The regulations incorporate the ISO rule that communication with the service provider is not required before the grant date. However, an “unreasonable delay” between the corporate action and the notification may be evidence that the corporation did not irrevocably intend to make the grant until notice was provided. As under the ISO regulations, “unreasonable delay” is not a defined term, but, in general, the standard seems intended to address cases in which, despite a stated grant date, there are indications that the service recipient was not in fact committed to making the grant; delaying notification can be a way to reserve the ability to revoke it.
The definition of “readily tradable” (regularly quoted by brokers or dealers making a market in such stock) is borrowed from the regulations under section 280G, as the concept is not pertinent to ISO grants. Similarly, the definition of “established securities market,” for purposes of section 409A generally, is defined by reference to Treasury Reg. section 1.897-1(m). In Revenue Ruling 2004-87, the IRS interpreted these terms in the context of section 280G and concluded that, when the stock issuer is in bankruptcy, trading may be impaired to such an extent that the stock is not “readily tradable,” even if some transactions take place on a few markets. While this rule would not specifically apply here, taxpayers could reasonably apply it by analogy.

Restricted Property

A transfer of property in connection with the performance of services, taxable under section 83, does not result in deferred compensation, regardless of whether the property is subject to a substantial risk of forfeiture. Similarly, benefits under funded, nonqualified plans of deferred compensation taxed under section 402(b) or as section 403(c) annuities are not within the scope of section 409A. Transfers of property must be distinguished from promises to transfer property in the future. A promise to transfer property is outside the scope of section 83 until the transfer occurs, and therefore is treated in the same manner as a promise to transfer cash in the future.

Separation Pay Plans

Another significant exception to the definition of section 409A deferred compensation covers separation pay plans that meet fairly stringent criteria. Separation pay is compensation conditioned on separation from service (including separation on account of death or disability), not amounts that could be paid without any separation (including on change in control, unforeseeable emergency, or on a date certain).

There are four basic types of 409A-exempt separation pay plans: (1) collectively bargained plans; (2) plans that provide for separation pay on an involuntary separation from service or voluntary separation as part of a window program; (3) certain foreign plans; and (4) plans that provide for certain reimbursements or in-kind benefits in connection with a voluntary or involuntary separation from service. There is also a catch-all exception for any other amounts provided only on separation from service that do not exceed the limit under section 402(g) for the year ($17,500 in 2013).

It is clear that the separation pay exception does not apply to amounts that are a substitute or replacement for deferred compensation to which the individual is entitled. The determination of whether a payment is a substitute for deferred compensation is based on the facts and circumstances. Amounts paid by reason of an otherwise voluntary termination are assumed not to be separation pay, although this presumption can be rebutted.

Involuntary Separation Plans

A separation pay plan is not subject to section 409A to the extent that it provides for payments on an involuntary separation from service or pursuant to a window program and the arrangement meets the following conditions:

- The payments do not exceed twice the lesser of (1) the service provider’s annualized rate of compensation for the preceding taxable year (adjusted for certain increases that would have been received in the normal course of employment) or (2) the section 401(a)(17) compensation limit for qualified plan purposes as in effect for the year in which the separation from service occurs. For 2013, the compensation limit is $255,000, so the highest possible separation payment commencing in 2013 is $510,000.

- The payments are made no later than the end of the second calendar year after the year in which the employee separates from service.

A “window program” is defined as one under which employees are given incentives to leave voluntarily during a limited time period.

To qualify for this exception, the amounts involved cannot be available under any other circumstances. Therefore, section 409A-exempt separation pay must be in addition to other deferred compensation. However, even if involuntary termination pay exceeds the amount permitted for this exception, an amount equal to the limit can be excepted from the section 409A rules. This is particularly important for “specified employees,” whom section 409A subjects to a six-month delay on distributions in connection with a separation from service. Using the separation pay exception, an employer is able to
adopt a "true" severance pay program and make earlier payments to specified employees who leave involuntarily, as long as the payments are structured to fit the exception. Note that it is also permissible to "stack" exceptions: all amounts that are within the short-term deferral exception, for example, are exempt from section 409A, and do not count against the amount available under the separation pay exception. For planning purposes, the two exceptions have different advantages. The separation pay exception allows payments to continue for an extended period, making it easier to stop payments, for example, on breach of a related non-compete agreement. The short-term deferral exception, however, has no monetary limit and does not include the restriction that payments may only be on involuntary termination, and so can also allow for payment on the lapse of any other substantial risk of forfeiture.

Reimbursement and In-Kind Benefit Plans

This exception covers any reimbursement includible in gross income provided upon voluntary or involuntary separation from service, including, but not limited to, reimbursement for expenses that would otherwise be deductible by the service provider under section 162 or 167 (without regard to the limitations based on adjusted gross income), reasonable moving or outplacement expenses, and medical expenses. Reimbursements for moving expenses can include reimbursement of the loss incurred on the sale of a primary residence in connection with a separation from service. If, instead of reimbursement, the employer provides benefits in kind, they are exempt from section 409A to the extent that an analogous right to reimbursement would be exempted. In-kind benefits include office space and use of company cars or aircraft.

Generally, expenses must be incurred, or in-kind benefits must be provided, by the end of the second year following the year in which separation from service occurs, and all reimbursements must be paid by the end of the third year. For medical expenses, however, the reimbursement can continue through the applicable COBRA continuation period. The exemption is not negated if the plan extends the right to reimbursements or in-kind benefits beyond the permitted period, though later payments must comply with the section 409A rules.

Indemnifications, Liability Insurance, Legal Settlements

The regulations exclude indemnifications, liability insurance, and legal settlements from the definition of nonqualified deferred compensation. With respect to legal settlements, however, the regulations include a tracing rule to prevent settlements from altering the timing of compensation that would otherwise be subject to section 409A.

Educational Benefits

There is an exception for educational benefits — including tuition and books for educational courses other than education involving sports, games, or hobbies — to the service provider (but not to anyone else).

Qualified Plans and Other Tax-Favored Retirement Vehicles

Section 409A does not apply to qualified pension, profit-sharing, and stock bonus plans (sections 401(a) and 403(a)), tax-sheltered annuities and custodial accounts (section 403(b)), simplified employee pensions (section 408(k)), SIMPLE retirement accounts (section 408(p)), eligible deferred compensation plans (section 457(b)) or qualified governmental excess benefit arrangements (section 415(m)). The final regulations also exclude plans covered by section 402(d) (certain plans with a foreign-situs trust) and certain Puerto Rican plans, as described in section 1022(i)(2) of the Employee Retirement Income Security Act of 1974, as amended.

Welfare Benefit Plans

Welfare benefit plans, including bona fide medical, vacation, sick leave, compensatory time off, disability, and death benefit plans are exempt from section 409A even though some of the benefits under these plans, such as retiree medical benefits, may be payable in the future. Taxable medical benefits, such as certain medical expense reimbursements for highly compensated employees under a self-insured employer plan, are not excepted from section 409A. The regulations do not provide further guidance on what constitutes a bona fide sick leave or vacation plan. Taxpayers may interpret these terms by reference to the guidance under section 457.

Death and disability benefits are defined by reference to the Federal Insurance Contributions Act (FICA) regulations under section 3121(v)(2). In general, death and disability benefits must be
payable only upon the specified event. The payment of deferred compensation as a death benefit to a service provider’s beneficiary is not an exempt welfare plan.

Note that discriminatory medical expenses not excepted by this rule may be excepted as separation pay as discussed above.

Foreign Plans

There are several exemptions aimed at limiting the effect of section 409A on nonresident aliens and on U.S. citizens or residents who participate in non-U.S. plans. The regulations confirm that section 409A does not apply to deferred compensation contributions or accruals to the extent they are exempt from U.S. taxation under an applicable tax treaty. As noted above, a plan that results in income under section 402(b) does not provide for deferred compensation.

In addition, the regulations limit the reach of section 409A as follows:

- Deferred compensation that is not U.S.-source income and that was earned and vested while the service provider was a nonresident alien is exempt from section 409A, including future earnings to the extent the earnings are not excessive. This exemption is important for an individual who later becomes a U.S. taxpayer (by taking a job in the U.S. after accruing deferred compensation abroad, for example).

- Deferred compensation also does not include deferrals by a U.S. citizen or resident alien that would have constituted “foreign earned income” (under section 911(b)(1), without regard to section 911(b)(1)(B)(iv)) if paid directly, except to the extent that, when combined with current compensation, it exceeds the foreign earned income exclusion.

The same principle applies to deferred compensation that, if directly paid, would be exempt under the exclusions applicable to bona fide residents of Guam, American Samoa, the Northern Mariana Islands (section 931), and Puerto Rico (section 933), and to foreign employees of foreign governments and international organizations (section 893).

Where a nonresident alien’s deferred compensation is U.S.-source income and not excluded from U.S. taxation by treaty, it is nonetheless exempt from section 409A to the extent that it does not exceed the section 402(g) limit in effect for the year.

Benefits under foreign social security systems are excluded from section 409A, whether or not a social security totalization agreement is in effect.

Tax equalization adjustments (made to offset differences between U.S. and foreign effective tax rates where income is subject to tax in more than one jurisdiction) for U.S. persons working abroad are excluded from section 409A, so long as they are paid by the end of the second taxable year following the year in which the service provider’s U.S. tax return is required to be filed for the year to which the compensation subject to the equalization payment relates. If the service provider’s foreign tax return or tax payment for the year to which the underlying compensation relates is due later than the U.S. tax return, however, the tax equalization payment can be made as late as the end of the second taxable year after the foreign tax return or payment is due. Finally, payments related to audits or litigation are excepted if paid by the end of the year following the year incurred.

It is important to note that there is no exclusion for other expatriate benefits, such as housing subsidies and cost-of-living differentials. However, in most cases these allowances are paid currently and, therefore, often will fit within the short-term deferral exception. The special rule for tax equalization payments is designed to accommodate the delays inherent in calculating taxes and filing returns under multiple tax systems.

The regulations also include exceptions related to benefits under certain broad-based retirement plans. The exception is more limited for U.S. citizens and lawful permanent resident aliens than it is for nonresident aliens, other U.S. residents, and bona fide residents of U.S. possessions (as defined in section 937). A broad-based retirement plan is a written plan designed to provide retirement benefits that are significant and nondiscriminatory, and that covers a wide range of employees, substantially all of whom are nonresident aliens.

For U.S. citizens and lawful permanent residents who are not eligible under a U.S. qualified employer plan, nonqualified deferred compensation does not include nonelective benefits under a broad-based retirement plan to the extent that they are based on modified foreign earned income and do not
exceed the limits applicable to qualified plans. “Modified foreign earned income” is foreign earned income as defined in section 911(b)(1), but includes amounts received after the close of the taxable year following the taxable year in which the services are performed and is determined without regard to the section 911(b) residency requirements, so that bona fide foreign residence or presence abroad for at least 330 days in a 12-month period is not necessary. The proposed regulations would have limited this exception to plans maintained by a non-U.S. employer; the final regulations did not adopt that limitation.

For nonresident aliens, certain other residents, and bona fide residents of possessions, there is a general exemption for benefits accrued under a broad-based foreign retirement plan.

In the first year in which an individual becomes a resident alien, the regulations provide an additional period during which any necessary plan amendments or deferral elections can be made. This period extends to the end of the calendar year of the change in status. Any election can relate only to amounts not previously paid or made available. In addition, these special rules are available only to individuals who have been nonresident aliens for the prior three consecutive calendar years.

Deferral Arrangements for Independent Contractors

Independent contractors (other than corporate directors and persons who provide management services) are generally exempt from section 409A if they provide significant services in the same trade or business to two or more parties unrelated to each other (and unrelated to the independent contractor). Whether a party is related for this purpose is determined by reference to sections 267(b) and 707(b)(1), subject to two modifications: (1) the 50 percent control test in those sections is reduced to 20 percent, and (2) an individual’s “family” is expanded to include spouses of siblings, ancestors, and lineal descendants. Parties are also considered to be related if they are engaged in trades or businesses under common control (as defined in section 52(a) and (b), which differ slightly from section 1563(a) and sections 414(b) and (c)). The 409A exemption is not available for an independent contractor’s deferred compensation from a related party unless the arrangement with the related party is substantially similar to those with unrelated parties.

Whether the services provided to two or more parties are “significant” is a question of “facts and circumstances,” but the final regulations include a safe harbor: an independent contractor who is in fact providing services to two or more independent parties is deemed to be providing significant services to two or more so long as none of them accounts for more than 70 percent of total revenue for the taxable year. A provider that has met this test for at least three consecutive years may assume that it will be met in the current year, unless he has reason to know otherwise at the time of a deferral.

As noted above, the exclusion for independent contractors is not available to directors or for providers of “management services,” which include “services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient” and “investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets (including investments in real estate), such as a hedge fund or a real estate investment trust.”

Other Important Definitions

Service Provider

Section 409A applies only to deferred compensation earned by service providers. A “service provider” is (1) an individual, (2) a personal service corporation (or an entity that would be a personal service corporation if it were a corporation), or (3) a qualified personal service corporation (or an entity that would be a qualified personal service corporation if it were a corporation). Corporations, S corporations, and partnerships can all be “service providers” under these provisions. However, only cash­basis service providers are subject to section 409A.

Service Recipient

“Service recipient” includes the entity for which services are performed and all members of its controlled group, applying the definitions of “controlled group” in section 414(b) and (c). The section 414(b) and (e) definitions are generally similar to the “controlled-group” definition in section 1563(a), except that foreign and noncorporate entities are included in a group.

In addition to this general definition, the regulations also provide specific definitions of service recipient for use in determining whether there is a “separation from service” and under the stock
right exception. In both cases, service recipients have the ability to use a lower level of ownership to identify the service recipient.

Plan

A “plan” consists of all deferred compensation arrangements of the same type between a single service provider and a single service recipient, without regard to how many different documents embody these arrangements or how many other service providers they cover. The definition of “plan” and the aggregation groups are important, because a violation of section 409A results in inclusion in income of all amounts deferred by the participant under the plan with respect to which the violation occurred and all other plans in the aggregation group. The plan aggregation rules are modified to the extent that there is a plan document failure: If the failure is solely due to noncompliance with the written plan requirement, it will affect only deferred compensation provided under the unwritten arrangement. There is no effect on the service provider’s other, written plans in the same category.

These aggregation groups are:

- Account balance plans that provide for nonelective deferrals, including matching contributions, other than ones that fall into more specific categories outlined below;
- Account balance plans that provide for elective deferrals to the extent that the deferred amounts can be separately identified and are not identified in the more specific categories outlined below;
- Nonaccount balance plans, other than those identified in the more specific categories outlined below;
- Separation pay plans that pay only on an involuntary separation from service (including payments meeting the “good-reason” requirements) or pursuant to a window program, other than in-kind benefit or reimbursement plans;
- In-kind benefit or reimbursement plans, to the extent that the right does not constitute a substantial portion of overall compensation or of amounts received on account of a separation from service;
- Split-dollar life insurance arrangements;
- Foreign plans under which substantially all the participants are nonresident aliens for service providers that do not participate in substantially similar domestic arrangements;
- Stock right arrangements subject to section 409A; and
- All other arrangements not otherwise categorized above.

The definitions of “account balance” and “nonaccount balance” plan are borrowed from the FICA tax regulations under section 3121(v)(2) applicable to deferred compensation. Generally speaking, these types of plans correspond to defined contribution and defined benefit plans, respectively.

Written Plan Requirement

A plan must be in writing. A plan is “established” when a service provider has a binding right to deferred compensation. The written document may be adopted subsequently, but no later than two-and-a-half months after the end of the taxable year in which the binding right arose. (The two-and-a-half month extension is not allowed if any distributions are payable in the year immediately after the initial year.) The plan’s formal date of establishment is the earlier of (1) the date on which a binding right first arose or (2) the latest of the date of adoption, the stated effective date, or the date on which all material terms are reduced to writing.

The material terms of the plan may be set forth in more than one document. They include the amount (or method or formula for determining the amount) of deferred compensation provided under the plan and the time and form of payment.

A plan that lets participants make deferral elections must specify in writing, before any election becomes irrevocable, the conditions under which an election may be made. A written plan does not have to specify the conditions under which payments may be accelerated, although any acceleration must comply in operation with section 409A.
A written plan that covers a specified employee must include a provision requiring the six-month delay before the specified employee may receive a distribution on account of separation from service. This provision must be included as soon as the service provider becomes a specified employee or on the earliest date on which it might be possible for the service provider to receive a distribution on separation, whichever is later.

**Savings Clauses**

The regulations specifically state that general provisions of a plan that purport to nullify noncompliant plan terms, or to supply required specific plan terms, are disregarded. Thus, if a plan contains terms that do not meet the requirements of 409A and the regulations, or fails to contain a required plan term, it violates 409A and cannot be saved by general language mandating compliance. This rule would not affect a provision that required interpretation of the plan document in a manner consistent with compliance with section 409A, or an exception thereto.

**Substantial Risk of Forfeiture**

For purposes of section 409A, a substantial risk of forfeiture exists so long as the receipt of deferred compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. A condition must relate to the services provided or to the service recipient’s business activities or organizational goals. For example, a promised bonus is subject to a substantial risk of forfeiture if the service provider must continue as an employee for a specified period of years or until a specified event, such as the service recipient’s IPO. A substantial risk of forfeiture also exists if no further services are required but the bonus is conditioned on a business-related event, such as an IPO within a limited period of time or at no less than a specified price. Conditions unrelated to the service recipient are not substantial risks of forfeiture, e.g., forfeiture if an employee’s child does not enroll in college.

Although this definition parallels that used for purposes of sections 83 (transfers of property in connection with the performance of services) and 457(f) (unfunded deferred compensation plans of tax-exempt organizations), there are some notable differences. First, a requirement to refrain from performance of services (a “noncompete agreement”) cannot create a section 409A substantial risk of forfeiture. Second, any extension of a substantial risk of forfeiture after the beginning of the service period is not effective; the risk is considered to end in accordance with the original plan terms. Third, elective deferrals of compensation cannot be subject to a substantial risk of forfeiture unless the amount subject to the risk (other than earnings or amounts that would otherwise be paid for future compensation) is materially greater than the amount that is electively deferred.

The regulations include a separate definition of “involuntary separation from service.” (The general definition of “separation from service” is discussed below in connection with permissible distribution events). Whether a separation is involuntary is important for the separation pay plan exception and for the short-term deferrals that are contingent on an involuntary separation from service. Notably, the regulations address when a termination by the service provider for good reason will be treated as an involuntary separation from service.

**Dividends, Dividend Equivalents and Earnings**

It is permissible for a plan to treat earnings separately from initial deferrals. Therefore, rather than distribute earnings at the same time as the deferred amount, a plan may pay them out as short-term deferrals two-and-a-half months after the end of the calendar year in which the earnings accrue, or it may distribute them in accordance with a separate, section 409A-compliant arrangement. The extent to which amounts are considered “earnings” rather than initial deferrals is determined by reference to the earnings rules in the FICA regulations. Thus, for account balance type plans, earnings must reflect the rate of a predetermined actual investment or a reasonable rate of interest, and for nonaccount balance type plans, an increase due solely to the passage of time using reasonable actuarial assumptions and methods. To the extent that amounts are in excess of the amount that can be treated as earnings, they are treated as deferrals, and are subject to the terms of plan applicable to initial deferrals, not earnings.

Dividend equivalents are also covered by this rule, and can be paid currently or under a separate deferred compensation arrangement that provides for short-term deferrals or complies with section 409A. In general, the existence of a separate dividend equivalent right will not affect the exemption of the related stock right. However, a dividend equivalent right cannot provide for payment on exercise of a related stock right, as this distribution schedule does not comply with the short-term
deferral rule or section 409A. Furthermore, such a payment schedule is treated as a reduction in purchase price that will result in the loss of the stock right exemption for the underlying stock right.

**Compliance with section 409A**

**Initial Deferral Requirements**

**General Rule for Timing of Elections**

An election complies with section 409A only if it is made by the end of the year before the calendar year in which the related services are to be performed. Elections with respect to compensation from a service recipient with a fiscal year can be made on that basis, if the compensation is determined on the basis of the fiscal year. This exception does not apply to salary or other compensation that is not earned on the basis of the fiscal year.

**Short-Term Deferrals**

If an arrangement would otherwise constitute a short-term deferral, then an “initial” deferral election can be made in accordance with the rules for changes in deferral elections using the vesting date as the original payment date. These rules are discussed in more detail later. Their effect is that the time and manner of distribution of a short-term deferral may be changed only if the new election is made at least 12 months prior to vesting and the distribution date is postponed for at least five years.

**Forfeitable Rights**

A deferral election with respect to compensation subject to a substantial risk of forfeiture can be made up to 30 days after the grant, provided that the participant is required to perform services for at least 12 months after the date of an election. An arrangement will not fail to require 12 months of continued service merely because the amounts become vested on disability, death, or a change in control. If one of these events occurs, however, the deferral election will be effective only if it complies with the general rules (e.g., the election was actually made prior to the beginning of the year in which the related services are provided).

Note that the requirement that at least 12 months of services must be required after the date on which any election is made may mean that at least 13 months of service are required from the grant date. In the event that vesting is accelerated by disability, death, or a change in control during this 12-month period, any election under this rule is voided.

**Initial Eligibility**

A deferred compensation plan can allow a service provider to make a deferral election within 30 days after he or she becomes eligible to participate for the first time, but only with respect to compensation for services performed subsequent to the election. Compensation based on a performance period (e.g., an annual bonus), is deemed earned ratably throughout the period, so that a deferral election may be made for a proportionate share, based on the relative length of time before and after the election.

With respect to nonelective “excess benefit plans,” a participant can be treated as newly eligible during the first 30 days of the first taxable year immediately following the taxable year in which the participant first accrues a benefit. The election can apply to amounts accrued for services before the election. For this purpose, “excess benefit plan” is defined as including any nonelective plan that is linked to a qualified employer plan and provides benefits without regard to any limits on benefits under the Code. This definition of excess benefit plan is broader than that used for ERISA. For example, it includes a plan that provides benefits in excess of the section 401(a)(17) limitation on compensation that may be taken into account under a qualified plan. On the other hand, it excludes any elective plan, as well as any plan that provides benefits in excess of a limit established by its own terms, rather than under the Code.

**Performance Pay**

Deferral elections relating to performance-based compensation are permitted as late as six months before the end of the performance period, provided that the performance period is at least 12 months long and the service provider performs services continuously from the time performance criteria are established through the date of the election. In addition, the deferral election cannot be made after the amount of compensation has become readily ascertainable.
Compensation is performance-based if it is contingent on pre-established organizational or individual performance criteria. To be pre-established, the criteria must be set forth in writing no later than 90 days after the beginning of the performance period. They do not have to be approved by the service recipient’s compensation committee or stockholders.

Subjective criteria are permissible, so long as they are bona fide and related to individual performance or to the performance of a group that includes the service provider. The determination that the criteria have been satisfied cannot be made by: the service provider; a member of his family or the spouse of any family member; or a person under the effective control, of the service provider or a member of the service provider’s family.

“Performance pay” can include compensation based solely on an increase in the value of the service recipient or the service recipient’s stock after the date of grant, but a plan that provides for a payment equal to the value of a specified number of shares is not performance-based compensation merely because the value of the stock determines the amount of the payment. Instead, the compensation must be contingent on attainment of a predetermined value or other performance goal. Finally, this provision does not modify the exception for stock rights, which precludes any additional feature for deferral after the exercise or disposition of the stock right.

A plan may provide both performance pay and other, nonperformance-based compensation. In such a case, it can be bifurcated and the portion meeting the performance pay criteria can be deferred under the special rule for performance pay.

Compensation will not fail to be performance-based merely because it is also payable in the event of death, disability, or a change in control. If the payment is in fact made on the occurrence of one of these events, however, it is not performance-based compensation and a deferral election under these rules is disregarded.

An election cannot be made after the amount of performance-based compensation is readily ascertainable. Where the amount to be paid has been specified, it is readily ascertainable as soon as it is substantially certain the performance conditions will be met. If the amount varies with performance, it is readily ascertainable when both calculable and substantially certain to be paid. These performance-based compensation election rules apply to the extent an amount is not readily ascertainable. Thus, an election may be permissible with respect to a portion of a payment, but not the entire amount.

Deferral elections with respect to bonuses for newly eligible participants depend on the circumstances. A participant who first becomes eligible under a deferred compensation plan may be able to make an initial deferral election with respect to a bonus, provided that the election is limited to the pro rata portion of the bonus related to the post-election portion of the year. However, a newly eligible participant in a performance pay plan may be unable to defer any of the bonuses, even if there are more than six months before the end of the performance period, because he may have started performing services after the performance criteria were established.

Separation Pay

A deferral election with respect to payments on separation from service that are negotiated at arm’s length at the time of the separation is timely if made prior to the time the service provider has a legally binding right to the payments. This provision does not apply to amounts with respect to which there is a legally binding right before negotiations at the time of the separation from service, including a right subject to a substantial risk of forfeiture. For those amounts, the general rules on deferral elections and changes in distribution timing are applicable.

Commission Income

Sales commissions may be deferred before the beginning of the year in which the customer pays the service recipient. Investment commissions, based on the value of an investment or its appreciation, may be deferred only if the election is made at least 12 months before the commission is determined. Commissions on transactions with parties who are related to either the service provider or the service recipient are ineligible for deferral, unless a substantial portion of the service provider’s commission income arises from dealings with unrelated parties and the terms of his compensation are the same for both related and unrelated transactions.

Other Provisions

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A special rule allows school teachers and other employees who work for only part of the year on a recurring basis to elect to spread their pay over 12 months without violating section 409A. The election must be made before the service period begins (e.g., before August for a typical teacher) and may not defer compensation beyond the end of the thirteenth month after the beginning of the service period.

Changes in elections under a cafeteria plan are disregarded in determining whether the deferral rules have been complied with, even if the election changes the amount of compensation taken into account in applying a deferral election. The final regulations added this provision to eliminate the potential for failures by plans that exclude section 125 contributions from plan compensation.

Elections that comply with the Uniformed Service Employment and Reemployment Rights Act of 1994 are deemed to comply with section 409A.

Amounts that are earned in a final payroll period but paid in the next year are generally treated as compensation for services in the year of payment, with the result that the deferral election in effect for the year of payment can be applied to these amounts. A plan is permitted to adopt a different rule, but it may not take effect until 12 months after the amendment is adopted.

**Plans Linked to Qualified Plans or Broad-Based Foreign Arrangements**

If the benefits under a nonqualified plan or broad-based foreign plan are calculated using the same formula as a qualified plan, but without regard to limitations imposed on qualified plans under the Code (or other applicable law), or are offset by benefits under a qualified plan, changes in the applicable Code limitations or qualified plan formula generally are not deferral elections or accelerated distributions, even if they result in greater or lesser benefits under the nonqualified plan, provided that the time and form of the nonqualified distributions do not change.

Specifically, none of the following actions or inactions under a qualified plan or broad-based foreign plan has section 409A consequences, even if it affects benefits under a nonqualified plan:

- Action or inaction by a participant that results in the election, elimination, or reduction of a subsidized or ancillary benefit;
- A plan amendment that adds or eliminates a subsidized benefit or ancillary benefit, or that increases accrued benefits or freezes or limits future accruals of benefits;
- A participant’s making or failing to make elective deferrals, so long as the resulting increase or decrease in nonqualified deferred compensation does not exceed the section 402(g) limit ($17,500 for 2013, or $23,000 for participants age 50 or older); or
- A participant’s making or failing to make the deferrals or employee contributions necessary to obtain the maximum possible matching contributions under the qualified plan, provided that the amount involved does not exceed 100 percent of the amount that would be available under the qualified plan.

The latter two limits are independent of one another. Thus, a section 401(k) wrap plan may allow the amount deferred under the nonqualified plan to be increased by an amount up to the section 402(g) limit and by an additional amount equal to the matching contribution that would be available under the qualified plan. These limits are increased by the section 414(v) catch-up contribution limit ($5,500 for 2013) if the service provider is at least 50 years old.

For section 401(k) wrap plans and other nonqualified plans linked to qualified plans that provide for deferrals and matching contributions, a shift between the qualified and nonqualified plan is permissible as long as it does not exceed the section 402(g) limit for the year, adjusted for catch-up contributions. For 2013, this amount is $17,500 plus $5,500 for catch-up contributions. In addition, it is permissible to shift up to 100 percent of the amounts that would have been made as matching contributions between the two plans.

Not all plan designs linking qualified and nonqualified plans satisfy the requirements of section 409A. For example, if an employee cannot defer any amount under a nonqualified plan unless he makes the maximum permitted deferral under a qualified plan, and he can freely change the qualified plan deferral, the nonqualified plan does not comply with section 409A. The rationale is that this design is tantamount to letting the employee make a nonqualified deferral election after the beginning of the
year, in violation of the deferral rules, since he can negate a timely election by the simple device of reducing his qualified plan deferrals late in the year.

Finally, plan sponsors need to consider general timing issues related to nonqualified plan deferrals. For example, qualified plan deferral elections operate on a "cash basis," i.e., the deferral election is applied to any amounts that would otherwise be made during the period the election is in effect. For the nonqualified plan, however, the initial deferral rules apply. For example, a nonqualified deferral election made in December 2013 can apply to salary otherwise payable in 2014, but is too late to apply to the 2013 bonus to be paid in March 2014, even though an election under the qualified plan made at the same time would be effective.

**Distribution Elections and Changes in Timing of Distributions**

Section 409A permits the distribution of deferred compensation only upon the occurrence of one of a limited number of events, requires that the distribution events be specified in advance, and restricts the acceleration of distributions.

**Distribution Events**

**Separation from Service**

Separation from service is a permissible distribution event. Generally speaking, separation for an employee occurs at termination of employment; for an independent contractor, when the agreement under which he performs services expires; and for a corporate director, when his term of office ends.

**Employees**

An employee separates from service when he dies, retires, or otherwise terminates employment. Usually, that event is easy to recognize, but complications may arise when individuals go on leave or reduce their working hours without completely severing their relationship with their employer.

A bona fide leave of absence, including military leave or sick leave, from which the employee is expected to return, is not treated as terminating the employment relationship until the later of the passage of six months (up to 29 months, at the employer's option, in the case of disability leave) or the expiration of any contractual or statutory right to return to employment. Separation occurs at the six-month mark or the expiration of reemployment rights, unless the facts and circumstances indicate that the expectation of a return to employment ended earlier.

The regulations provide somewhat objective standards for determining whether service providers who work reduced schedules have separated from service. An employee is considered to have separated when both he and his employer reasonably anticipate that his services will be permanently reduced to no more than 20 percent of the average level performed over the preceding 36-month period. For purposes of this standard, it is irrelevant whether the continuing services are performed as an employee or as an independent contractor. The regulations do not specify how the "level of services" is measured or what measuring period to use. In most cases, these matters will be intuitively obvious. Otherwise, the parties must act reasonably and in good faith. An employee on a paid leave of absence should be treated as performing services commensurate with the compensation that he receives, while unpaid leaves that do not result in termination of employment should be ignored in the computation.

If the level of services in fact drops to less than 20 percent of the prior 36-month average, a rebuttable presumption arises that the employee has separated from service. Continuation at a 50 percent or greater level raises a presumption that there was no separation. Levels between 20 percent and 50 percent result in no presumption; whether the employee has separated is purely a matter for facts and circumstances. The presumptions can be rebutted by showing that the parties reasonably failed to anticipate the actual level of services.

For example, if an employee receives a distribution of deferred compensation, purportedly on account of separation from service, but continues to perform services at 50 percent or more of his previous rate, he has a presumptive section 409A violation. The presumption can be rebutted by showing that his services were reasonably expected to fall below the 20 percent level. He might, for instance, have resigned with no intention of returning, then returned to employment after a brief interlude because of unforeseen circumstances.
Similarly, if an employee is presumed to have separated from service because his services have fallen below the 20 percent level, but he has not received a distribution required by the terms of the plan, the parties can show that they reasonably expected his services to continue at a higher level. In that case, separation from service occurs when the parties reasonably anticipate that the lower level of services will be permanent.

A plan may explicitly alter the level of services needed for a separation from service to any percentage greater than 20 percent and less than 50 percent. A plan-created definition must be adopted before deferrals are made and cannot be altered except in accordance with the rules governing changes to the timing of distributions.

**Independent Contractors**

For independent contractors, a separation from service occurs on the expiration of all contracts under which services are being provided to a service recipient, provided that the service relationship is terminated completely and the parties do not anticipate its renewal. Under a safe harbor rule, distributions to an independent contractor are deemed to be made on account of separation from service if, under the terms of the plan, they are made at least 12 months after contract expiration and the former independent contractor performs no services for the service recipient, as either a contractor or an employee, during that interval.

**Services in More than One Capacity**

In general, services in any capacity are considered in determining whether a service provider has separated from service. Hence, for example, serving as a consultant after terminating employment may negate what would otherwise be a separation. The regulations do, however, allow services as an employee to be analyzed separately from services as a corporate director (or as a holder of an analogous position for an unincorporated entity), provided that any deferred compensation plan available to the individual as a director is comparable to plans offered to non-employee directors. Under this rule, continued service on a board of directors will not prevent the receipt of distributions on account of separation from service as an employee. On the other hand, someone who leaves the board may receive a payout of the deferred director’s fees even if he remains an employee of the service recipient.

**Asset Transactions**

A sale of assets results in a separation from service for those employees who transfer to the employ of the purchaser. The buyer and the seller in a bona fide, arm’s-length transaction may agree that it will not be treated as resulting in separation from service, provided that all affected service providers are treated similarly. The agreement must be made in writing prior to the closing of the transaction. Any such agreement has no effect on whether the transaction is a “change in control” for purposes of section 409A.

This provision and several others give service recipients considerable flexibility in the context of mergers and acquisitions. An asset sale may, if desired, give rise to distributions on separation from service. Similarly, as is discussed below, a stock sale, which cannot be regarded as resulting in separation from service, may be an occasion for terminating deferred compensation plans and making immediate distributions. In either situation, consistency requirements are applicable. In addition, payments can be made for a change in control, a distribution event that can apply to either a stock or asset sale.

**Separation from Service and Specified Employees**

Specified employees may not receive distributions on account of separation from service until at least six months after the separation occurs (or upon death, if earlier). A plan that provides for installment or annuity distributions may comply with this requirement either by delaying the commencement of distributions for six months, or by making a catch-up distribution of the first six months of payments at the beginning of the seventh month.

The elements of the definition of “specified employee” are borrowed from the qualified plan definition of “key employee” in section 416(i). The most significant difference is that an individual may be a specified employee only if the service recipient for which he works has publicly traded stock as of his separation from service. The stock may be any class of stock of any member of the service recipient’s controlled group and may be traded “on an established market or otherwise.” The concept of “publicly traded” is somewhat broader than the concept of “readily tradable” used for purposes of setting the exercise price for stock rights.
An employee of a service recipient with publicly traded stock is a “specified employee” if he
(1) owns more than 5 percent of the stock of the service recipient or of any member of its controlled
group; (2) owns more than 1 percent of the stock and has compensation from the service recipient in
excess of $150,000 per year (not indexed); or (3) is an officer of the service recipient with compensation
in excess of $145,000 per year (indexed). Officer status is based on the nature of one’s duties, not on
title, and is limited to the 50 highest-paid officers.

The compensation used to identify specified employees is defined under section 415. By
default, none of that section’s safe harbors, special timing rules, or other special rules are used; but a plan
may incorporate any of them, without regard to how the service recipient’s qualified plans define section
415 compensation. The definition must be consistently applied to all employees. Under the default
definition of compensation, non-U.S.-source compensation of nonresident aliens is taken into account.
Multinational companies will want to consider whether to elect to include it. While there may be some
additional administration associated with including non-U.S.-source compensation, the effect will
ordinarily be to reduce the number of U.S. officers included in the specified employee group.

As an administrative convenience, the final regulations allow plans to devise alternative
methods for identifying specified employees. The method must be reasonably designed to include
everyone who would be a specified employee under the statutory method, use an objectively
determinable standard that does not give any service provider a direct or indirect election regarding its
application, and result in no more than 200 service providers being identified as of any date.

Specified employees must be identified each year as of a uniform “identification date”
selected by the employer. The facts concerning stockholdings, compensation, and officer status as of that
date identify the specified employees, but the identifications do not become effective until the beginning
of the fourth calendar month after the identification date, or an earlier date chosen by the employer. The
identified individuals then remain specified employees for the next 12 months. A service provider’s
criteria for specified employee status may be changed, but changes cannot be effective until 12 months
after their adoption.

A plan document must include a provision that requires a six-month delay for distributions
on separation from service to a specified employee. The regulations provide different ways for
employers to identify specified employees, but require that these provisions be applied consistently. If a
plan does not include provisions for identification of specified employees, the default rules will apply.

The six-month delay applies only if the service provider is a specified employee upon
separation from service. Thus, it does not affect someone who would have become a specified employee
if he had not separated from service. If specified employees leave between the identification date and the
date on which the identifications become operative, they are not replaced. Suppose, for example, that the
50 highest-paid corporate officers are identified as specified employees on the basis of the facts that exist
on a December 31, 2013, identification date. The identification effective date is April 1, 2014. On March
1, 2014, an officer who was not a specified employee as of the prior year’s identification date separates
from service. He is not subject to the six-month distribution delay, because he is not yet effectively a
specified employee. Moreover, as of April 1, 2014, the company will have only 49, not 50, specified
employees.

If a payment on account of separate from service is subject to the six-month delay,
acceleration is permitted only in the event of death, and not on account of disability, change in control, or
an unforeseeable emergency during the six-month hiatus.

The regulations provide special rules for identifying specified employees in the context of
corporate transactions.

Fixed-Time (or Pursuant to a Fixed Schedule) Specified Under The Plan

A plan may provide that distributions will be made on a fixed date, or during a specific
calendar year. Also permitted is distribution in installment or annuity form pursuant to a fixed schedule.
The schedule can be linked to a specified date, to another permissible distribution event, or to the date on
which a substantial risk of forfeiture lapses. A plan might, for instance, provide that deferred
compensation will be forfeited if the service provider leaves within 10 years, unless the service recipient
has an earlier IPO. It could then provide that, upon vesting (the earlier of the completion of 10 years of
service or the IPO date), the deferral will be distributed in installments over five years. When a vesting
date is used as the basis for a fixed schedule, however, the parties may not voluntarily accelerate vesting
as a way of accelerating the payout. Instead, even if vesting is accelerated, the distribution must follow the vesting schedule as initially set out in the plan.

A distribution date is not fixed, and does not comply with section 409A, if it is not currently ascertainable or is contingent on an event whose time of occurrence is not already known. A plan could not, for instance, specify “the date (or year) on which profits reach X” or “the date of the employer’s IPO” (unless those events also constitute vesting conditions).

Installments may be calculated using an objective and nondiscretionary formula, such as the one used for determining minimum required distributions for defined contribution plans. A formula may include a cap on each year's distributions, either to an individual or to a group, provided that the cap is objective and nondiscretionary, and the plan includes a nondiscretionary formula for allocating any required reductions. For example, if a plan provides that payments to all service providers cannot exceed 10 percent of profits in any year, it would also have to state how that limit will be implemented, e.g., through a pro rata reduction of all participants’ distributions. A formula may also offset benefits by Social Security benefits or payments under a disability plan, despite the fact that the future amounts of those reductions may be currently unknowable, provided that these adjustments result in forfeiture rather than merely in deferral of the scheduled payment to a later date and that any disability offset is under a plan that covers a substantial number of service providers and was established before the particular service provider became disabled.

A plan that reimburses expenses or provides in-kind benefits, such as a post-retirement medical plan, is treated as distributing benefits in accordance with a fixed schedule if it sets forth an objective, nondiscretionary definition of the benefits, states the period over which they will be paid, provides that benefits in one year do not affect those payable in any later year, and does not allow benefits to be cashed out or exchanged for other benefits. In addition, reimbursements must be paid no later than the end of the taxable year after the year in which the reimbursable expense is incurred.

Medical plans may include lifetime limits on benefits or other maximum benefit levels. For a health reimbursement account, the maximum dollar credit available under the plan is a permitted form of maximum benefit.

Tax gross-up payments are also considered to provide for distributions on a fixed schedule if the payments are made no later than the end of the year following the year in which the underlying taxes are paid. A similar rule applies to a right to reimbursement for expenses incurred in defending an audit or litigation related to tax liability.

It is not permissible for distributions to be triggered by an event whose date of occurrence is uncertain, such as the sale of an asset. The regulations also do not allow payments to a service provider to track receipts by a service recipient, subject to a limited exception that allows payments to be linked to sales made in the ordinary course of business.

Disability

For purposes of the distribution rules, “disability” is defined as inability to engage in any substantial gainful activity or the receipt of benefits for at least three months under an employer’s disability plan as the result of a medically determinable physical or mental impairment that is expected to result in death or continue for at least 12 months. The service provider need not receive a Social Security disability determination, although that is acceptable proof of disability. A plan may substitute a definition that is more limited than that provided in the regulations.

Death

Little additional guidance is needed about death. It should be noted, however, that the general rule that allows payments to be made by the end of the calendar year or, if later, two-and-a-half months after the event triggering the right to a distribution, applies. This rule, along with other guidance discussed below regarding events outside of the service provider’s control, allows additional time to make distributions on account of death and mitigates the risk that the section 409A additional tax will be imposed on those payments.

Change in Control

The provisions of the final regulations generally follow the proposed regulations. As in previous guidance, the regulations address corporate transactions only; taxpayers may apply the rules for corporations to partnerships by analogy pending further guidance. In addition, a nonstock, nonprofit
corporation may apply the change in effective control provisions (relating to a change in the composition of the board of directors) by analogy.

A change in ownership or control occurs with respect to a service provider only if the change relates to the corporation to which he provides services, or to the one that is liable for payment of the compensation (assuming that there is a bona fide business reason for its making the payment), or to one that is further up in a chain of corporations, each of which is majority-owned by its parent. There are three types of change in control, each based on distinct criteria:

- Change in ownership. A change in ownership occurs if a person, or a group of persons acting together, acquires more than 50 percent of the stock of the corporation, measured by voting power or value. Incremental increases in ownership by a person or group that already owns 50 percent of the corporation do not result in a change in ownership.

- Change in effective control. A change in effective control occurs if, over a 12-month period, (1) a person or group acquires stock representing 30 percent of the voting power of the corporation (reduced from 35 percent under the proposed regulations) or (2) a majority of the members of the board of directors of the ultimate parent corporation is replaced by directors not endorsed by the persons who were members of the board before the new directors' appointment.

- Change in ownership of a substantial portion of corporate assets. A change in control based on the sale of assets occurs if a person or group acquires 40 percent or more of the gross fair market value of the assets of a corporation over a 12-month period. No change in control results if the assets are transferred to certain entities controlled directly or indirectly by the shareholders of the transferring corporation.

It is possible for more than one corporation involved in a transaction to have a change in control for purposes of section 409A. A plan is permitted to provide a narrower definition of a change in control by increasing the percentages otherwise applicable under the provisions outlined above.

A plan sponsor may retain the discretion to terminate an arrangement in the event of a change in control, provided that it acts during the period beginning 30 days before and ending 12 months after the change and that it terminates all plans that are treated as a single plan under the aggregation rules for all participants affected by the change in control.

Delayed payments for the purchase of stock upon a change in control (e.g., earn-out payments)

Delayed payments are treated as paid in conformity with the distribution and the deferral election requirements so long as they are made on the same schedule and under the same terms and conditions as payments to selling shareholders generally and within five years of the change in control. Alternatively, post-termination payments that are subject to a substantial risk of forfeiture may be made under the short-term deferral rules. In addition, a substantial risk of forfeiture to be extended in connection with a change in control, without regard to the general rule that disregards any extensions made after the service period begins.

Unforeseeable Emergency

The statute’s definition of “unforeseeable emergency” is based on the regulations under section 457: Severe financial hardship arising from illness or accident of the service provider, spouse, or dependents; casualty loss; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. No hardship is considered to exist, however, to the extent that the financial need can be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the service provider’s assets to the extent the liquidation would not itself cause severe financial hardship, or by the cessation of deferrals under qualified and nonqualified plans. Examples of events that do not meet this standard are divorce and enrollment of a child in college. Finally, the amount distributed may not be more than is reasonably necessary to meet the emergency and pay any anticipated tax on the distribution. Neither the ability of a service provider to decide whether to seek a distribution on account of an unforeseeable emergency nor the service recipient’s retention of discretion over whether to allow the distribution constitutes an impermissible acceleration or deferral of a distribution.
Coordination of Multiple Distribution Events

A plan may provide for payment upon more than one distribution trigger. For example, it may state that distributions will begin upon the earliest of death, disability, an unforeseeable emergency, or attainment of age 62, or on the later of separation from service or attainment of age 70, with acceleration in the event of death. Similarly, when a distribution is made over a period of time, it may be accelerated by the occurrence of a new triggering event. For example, a plan may provide for payment of a series of 10 installment payments after separation of service, but require payment of the remaining installments in a lump sum if the participant dies or becomes disabled, or if the corporation undergoes a change in control. An exception, already noted, is that only death can accelerate a specified employee’s distribution on account of separation from service into the six-month period following separation.

Plans Linked to Qualified Plans or Broad-Based Foreign Arrangements

The regulations do not permit distributions under a nonqualified deferred compensation plan to be determined by distributions under a related qualified or other tax-favored plan.

Offsets

Deferred compensation payments may be offset by amounts owed to the service recipient by the service provider if the debts were incurred in the ordinary course of business, the entire offset in any year does not exceed $5,000, and the offset is taken at same time and in same amount as debt would have been due. Also permitted are dollar-for-dollar offsets to reflect Social Security or disability benefits, as discussed above in connection with fixed payment schedules.

Changes in Time and Form of Distribution

The date on which distributions will commence may be postponed (whether the postponement is at the election of the service provider or the service recipient) if the following conditions are met:

- The election to delay must be made not less than 12 months before a scheduled payment,
- The election may be effective no earlier than 12 months after it is made. If a distribution event occurs in the interim, the original distribution method must be followed.
- The postponement must be for at least an additional five years. Distributions on account of death, disability, or unforeseeable emergency may be postponed for shorter periods.

Life Annuities

An election to change from one life annuity form of distribution to another that is actuarially equivalent is not restricted by the rules governing changes in the timing of distributions. The following features do not prevent a form of distribution from being classified as a “life annuity,” though they are taken into account in determining whether the forms are actuarially equivalent:

- Term certain features;
- Pop-up features (e.g., under which payments increase upon the death of the beneficiary);
- Cash refund features;
- Leveling features with respect to Social Security or Railroad Retirement Act benefits; and
- Cost-of-living adjustments, subject to the same limitations as apply under the minimum distribution rules of section 401(a)(9).

Actuarial equivalence must be determined consistently, but the actuarial assumptions may change over time. A subsidized joint and survivor annuity is treated as actuarially equivalent to a single life annuity unless the survivor percentage exceeds 100 percent. For example, a single life annuity of $5,000 a month is deemed to be actuarially equivalent to one that pays $5,000 a month to the service provider and any amount up to $5,000 a month to his survivor.
A service provider's survivor annuitant may be freely changed at any time before the annuity begins, so long as any consequent change in scheduled payments reflects only the life expectancy of the new beneficiary.

Additions of Payment Events and Amendments

The addition of a new distribution event, other than distribution on the earliest of death, disability, or unforeseeable emergency, is treated as an acceleration or postponement of distributions. If it is an acceleration, it violates section 409A, unless it meets one of the exceptions discussed below. If it is a postponement, it must comply with the rules discussed above.

A cancellation or forfeiture of deferred compensation may be a disguised acceleration or postponement if the same benefit is then provided under a different guise. An example is the replacement of a distribution due on account of a separation from service by a purported section 409A-exempt separation pay plan in order to avoid the rule preventing distributions on separation from service to a specified employee for six months.

Permissible Delays

The regulations provide relief in certain situations in which delay in payment is unanticipated or is outside the control of the service provider. These exceptions protect service providers against unintended violations of section 409A, provided that payment is made promptly once the cause of the delay is removed. In all cases, delay is impermissible if it is at the explicit or implicit request of the service provider or if the service recipient treats similarly situated service providers on a basis that is not reasonably consistent. Delaying a distribution is permissible under these circumstances:

- A payment may be delayed if making it would jeopardize the ability of the service recipient to continue as a going concern.
- A service provider is not treated as violating section 409A if the service recipient refuses or, intentionally or inadvertently, fails to pay. In this situation, the service provider must take reasonable steps to enforce payment by notifying the service recipient within 90 days, and by taking further enforcement action within 180 days, after the payment is due. Failure to do so would suggest a voluntary, rather than an involuntary, delay.
- Any delay is permitted as necessary to comply with applicable law, such as federal securities laws.
- If a distribution at the scheduled time would be nondeductible under section 162(m), it may be delayed until either the first year in which it is deductible or separation from service (six months after separation from service for a specified employee). Either date may be selected, and the date may be different for different distributions. If the distribution is on separation from service, it must be made by the end of the year of separation, or if later, within two-and-a-half months after separation. (For a specified employee, the six-month delay period applies.)
- Payment may be delayed if the calculation of the amount to be paid is administratively impracticable due to events beyond the control of the service provider. The service provider may not cause the delay, as by failing to provide needed, reasonably available information to the person performing the calculation.

Acceleration of Distributions

The statute prohibits any acceleration of a distribution, except as provided in regulations. The regulations set forth the exceptions described below. Note that, in all cases, the service provider may have no say in whether the acceleration occurs. The decision must be made by the service recipient or automatically under the terms of the plan.

- A plan may give a service recipient discretion to cash out a service provider’s interest at any time, or may provide for automatic cashouts under specified circumstances, such as separation from service, so long as the value of the interest does not exceed the section 402(g) limit ($17,500 in 2013) and all arrangements that fall into the same category of plan are cashed out at the same time. A plan amendment calling for distributions under these circumstances may be adopted at any time before the date of the payment.
- A plan may also provide that scheduled installment distributions will be cashed out if their present value is less than a plan-established threshold, which may be any amount desired. A plan
amendment adding a provision of this sort must comply with the restrictions on amendments that postpone distributions.

- Acceleration to Comply with Legal Requirements or Pay Taxes. Plans may provide for accelerated distributions:
  - To comply with a divorce decree or domestic relations order;
  - To comply with federal, state, local or foreign conflicts of interest or ethics requirements;
  - To withhold taxes imposed as a result of income inclusion under section 457 resulting from the vesting of benefits under a plan of a governmental or tax-exempt employer;
  - To pay applicable employment taxes and withhold income taxes on any distribution made in accordance with the terms of the plan;
  - To pay applicable employment taxes and withhold income taxes on any amount required to be included in income upon failure to comply with section 409A; or
  - To prevent the occurrence of a nonallocation year (section 409(p)) with respect to an employee stock ownership plan sponsored by an S corporation.

**Accelerated Payments on Termination of the Plan**

A service recipient is permitted to terminate a plan and make accelerated distributions, but only if certain requirements are satisfied:

- All arrangements that fall into the same category of plan must be terminated with respect to all service providers who participate in them.
- Distributions on account of the termination may be made no earlier than 12 months after all action necessary to make the termination effective has been completed.
- All distributions must be completed no later than 24 months after the date of termination.

The service recipient may not establish any new arrangements of the same type for any service provider within three years following the date of termination, and the termination may not “occur proximate to a downturn in the financial health of the service recipient.” Employers that are in financial difficulty may terminate plans and accelerate distributions only with the approval of a bankruptcy court. Distributions in that case must be made in the year of termination or, if later, the year in which participants’ interests become vested. Distributions may be delayed if immediate payment is not administratively feasible.

Termination is also permitted upon a corporate liquidation taxable under section 331, with the approval of a bankruptcy court, or during the period beginning 30 days before and ending 12 months after a change in control, provided that all distributions are made within 12 months after the termination date.

**Substitutions**

The regulations provide that the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation. Generally, whether a payment or a right to a payment acts as a substitute for a payment of deferred compensation is determined based on all the facts and circumstances, but the regulations do identify several situations as raising a substitution issue, including situations in which a payment results in an actual or potential reduction of, or future offset to, an amount of deferred compensation, or situations in which a loan is secured through, or could be offsets against, deferred compensation. The regulation further provides that there is a substitution if a service provider’s right to deferred compensation is made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the service provider or the service provider’s beneficiary.” A forfeiture, or voluntary relinquishment, of a right to deferred compensation does not trigger a distribution, but a payment proximate to the forfeiture or voluntary relinquishment is presumed to be a substitute. This presumption can be rebutted by showing that the amount would be received in any event. Factors include whether the
amount that purportedly replaces the deferral was paid in accordance with a customary practice or is materially less than the forfeited or relinquished amount.

Grandfathered Deferrals

Deferred compensation is exempt from section 409A to the extent that the service provider is entitled to receive it, without any substantial risk of forfeiture, after December 31, 2004, and the plan has not been materially modified after October 3, 2004. Earnings with respect to a grandfathered deferral are also exempt. For this purposes, “substantial risk of forfeiture” is defined in the section 83 regulations, not in accordance with the narrower section 409A definition.

If a plan is materially modified after October 3, 2004, with respect to otherwise grandfathered amounts, those deferrals become subject to section 409A. As long as the plan post-amendment complies with section 409A, there is no failure associated with the amendment.

Funding Arrangements for Nonqualified Deferred Compensation

Section 409A prohibits two funding techniques for securing the payment of deferred compensation to executives — offshore rabbi trusts and plan provisions that transfer assets to a “secular” trust (one not subject to the claims of creditors) if the employer is in financial distress — by providing that either arrangement results in current income and additional tax of 20 percent (or more, if increases based on interest at the underpayment rate plus 1 percent also apply).

A rabbi trust is subject to the claims of the employer-grantor’s general creditors in the event of the employer’s bankruptcy. Section 409A provides that a trust setting aside assets to fund deferred compensation that is located outside the United States, regardless of whether the trust is subject to the claims of the employer’s creditors, results in current income equal to the amount set aside plus an additional 20 percent tax. This rule does not apply if substantially all of the services that gave rise to the deferred compensation were performed outside the United States in the jurisdiction in which the assets are held. The use of rabbi trusts in the United States is unaffected by this offshore funding provision.

Another technique that some employers have used to secure the payment of deferred compensation is to provide that assets will be placed beyond the reach of the employer’s creditors if the company’s financial condition deteriorated. Section 409A provides that a plan that includes a provision of this sort, or that provides for establishment of a rabbi trust in the event of a financial health event, is treated as funded, leading to immediate tax liability.

The final regulations do not provide further guidance on funding restrictions. The transition guidance provided in Notice 2006-33 continues in effect until further guidance is issued.

Income Inclusion and Reporting and Withholding Obligations

Income Inclusion

On December 5, 2008, proposed regulations were issued addressing the calculation of amounts includible in income and additional taxes imposed under section 409A(a). The proposed regulations are proposed to be generally applicable for taxable years beginning on or after the issuance of the final regulations. Taxpayers may rely on the proposed regulations in their entirety, but that taxpayers may not rely on part, but not all, of the proposed regulations.

Reporting Requirements

Section 409A imposes reporting obligations for deferred compensation. The IRS has stated that no reporting will be required for deferred compensation to which service providers had a legally binding right prior to January 1, 2005, under a plan that has not been materially modified after October 3, 2004, even if the deferrals were not vested before the end of 2004 and thus are not exempt from section 409A. Effective for amounts deferred after December 31, 2004, and income attributable to such amounts, service recipients are required to include information about deferrals on Forms W-2 (for employees) or 1099-MISC (for directors and independent contractors), if that form is otherwise required to be filed. Deferrals eventually will be reported using Code Y in Box 12 of Form W-2 or in Box 15a of Form 1099-MISC. However, the IRS, most recently in Notice 2008-115 and the proposed income inclusion regulations, suspended these reporting requirements. However, the IRS indicates that the annual reporting will likely be required once the recently issued income inclusion regulations are finalized.
Wage Withholding

Reporting and Withholding

Employers are required to withhold tax on income arising from violations of section 409A as if these amounts were wages received in the year of the violation. As indicated in Notices 2007-89 and 2008-115, these amounts are reported as wages paid on line 2 of Form 941, and in box 1 of Form W-2. Additionally, these amounts should be reported in box 12 of Form W-2, using Code Z. Amounts included in income are treated as supplemental wages for purposes of determining the amount of tax to be withheld regardless of whether the employer paid other wages to the employee during the calendar year. This withholding obligation does not extend to the additional 20 percent tax or interest penalties imposed by section 409A.

For independent contractors or other nonemployees, amounts includible in income must be reported as nonemployee compensation in box 7 of Form 1099-MISC and as section 409A income in box 15b of Form 1099-MISC.

Calculation of Amounts

Generally, the amount includible in gross income under section 409A(a) and required to be reported by the employer is the total amount deferred under the plan (meaning the aggregated plan) that, as of December 31 of the applicable calendar year, is not subject to a substantial risk of forfeiture and has not been included in income in a previous year, plus any amounts of deferred compensation paid or made available to the service provider under the plan during the applicable calendar year.

For purposes of determining taxable deferred compensation, the following rules are applicable under Notice 2008-115. Note that in each case, the amount includible in income is limited to amount no longer subject to a substantial risk of forfeiture.

- **Account Balance Plans.** The amount deferred as of December 31 of a calendar year equals the amount that would be treated as an amount deferred under Treas. Reg. section § 31.3121(v)(2)-1(c)(1) on December 31 of that calendar year if the entire account balance were treated as a principal amount credited to the service provider’s account on December 31 of that calendar year. These same calculation rules apply to a nonemployee participating in an account balance plan.

- **Nonaccount Balance Plans (Reasonably Ascertainable Amounts).** The amount deferred as of December 31 of a calendar year equals the present value of all future payments to which the service provider has obtained a legally binding right as of December 31 of that calendar year, calculated in accordance with Treas. Reg. section 31.3121(v)(2)-1(c)(2) as if the service provider had obtained all of such rights on December 31 of that calendar year.

- **Amounts Deferred Under Stock Rights Covered by section 409A -** The amount deferred as of December 31 of a calendar year equals the amount that the service provider would be required to include in income if the stock rights were immediately exercisable and exercised on December 31 of that calendar year.

- **Other Deferred Amounts -** The amount deferred as of December 31 of a calendar year must be determined under a reasonable, good faith application of a reasonable, good faith method. Generally, the use of an assumption with respect to a contingency that results in the amount deferred being the lowest potential value of the future payment will be presumed not to be a reasonable, good faith assumption unless clear and convincing evidence demonstrates that the assumption is reasonable.

SECA and FICA Tax

Amounts included in income pursuant to section 409A are generally included in self-employment income for purposes of tax under the Self-Employment Contributions Act (SECA).

The tax treatment of deferred compensation for FICA purposes is not affected by section 409A. Thus, the taxation of such amounts under section 3121(a) or 3121(v)(2), as appropriate, is not changed.

Correction Programs

Notice 2008-113 covers the correction of operational errors that are made during the same tax year as the failure occurs and the correction of certain operational failures. The relief is in addition to any other relief that would otherwise be permissible under generally applicable tax principles.
Notice 2010-6, as modified by Notice 2010-80, provides methods for taxpayers to voluntarily correct certain types of failures to comply with the document requirements of section 409A. In some cases, plans may be corrected without service providers having to include amounts in income under section 409A, while in other cases as much as 50% of the amount deferred under the plan must be included in income, subject to the 20% additional income tax rate (although not the additional premium interest tax). In addition, taxpayers taking advantage of the correction program are generally required to attach a statement to their tax returns. Correction under the notice isolates the document failure to the year of correction, so that the document failure will not taint prior years.