

## Section 409A Compliance Strategies — Plan Design and Administration

- Edward E. Bintz (202) 942-5045  
Edward.Bintz@aporter.com
- Douglas S. Pelley (202) 942-5423  
Douglas.Pelley@aporter.com

## Overview – Selected Topics

- Bonus Plans
- Severance Pay
- Releases
- Substitutions
- Golden Parachute caps and gross-ups
- Termination/Liquidation of Deferred Compensation Plans
- Accelerated Payments – Limited cashouts
- Plan Administration
  - Rabbi trusts
  - Inventory of plans
  - FICA

## Bonus Plans

- Can be 409A deferred compensation or designed as short-term deferral or no legally binding right
  - Generally preferable to be exempt from 409A
  
- Short-term deferral design
  - Require payment by March 15 (assuming calendar year); or
  - Require employment on date of payment (or other date during year of payment)
  - Should provide for payment during January 1 to March 15 period to protect against failure to pay by March 15
  - Potential trap – Consider impact of any rights to bonus in the event of termination, death or disability

## Bonus Plans (cont'd.)

- No legally binding right design – Discretionary bonuses can be exempt from 409A if do not provide a legally binding right to compensation in a future year
  
- Bonus plans subject to Section 409A
  - Must designate year of payment
  - Potential trap – If plan provides for bonuses to be paid after financial statements are issued, need to also specify year of payment

## Structuring Severance Pay

- May be structured as
  - Section 409A deferred compensation
  - Short-term deferral
  - Exempt under two-times/two-year exception (in whole or in part)
  - Exempt under window plan exception
  - Exempt under limited payments exception (\$16,500 limit in 2011)
  
- Generally preferable to structure as exempt from 409A
  - More flexibility
  - Avoid six-month delay

## Severance Pay – Short-Term Deferral Exception

- Severance structured to qualify as short-term deferral
  - Severance payment trigger (if it occurs) must in all circumstances occur within 2-1/2 months after close of year that payment is no longer subject to substantial risk of forfeiture
  - Payment must then be made within requisite 2-1/2 month period
- Severance pay conditioned on involuntary separation from service is subject to substantial risk of forfeiture until involuntary termination occurs
- Good reason termination (meeting good reason standards of regulations) qualifies as an involuntary termination
- Designate payments as installments for short-term deferral exception

## Severance Pay – Two-Times/Two-Year Exception; Limited Payments Exception

- Two-times/two year rule applies to separation pay provided only upon involuntary separation from service
  - To the extent it does not exceed two times lesser of (a) annualized pay for prior year or (b) Section 401(a)(17) limit (currently \$245,000) for year of separation, and
  - To the extent plan or agreement provides for it to be paid not later than the end of the second taxable year of service provider following service provider's taxable year of separation from service
  
- Potential traps
  - Severance also paid upon death or disability
  - Good reason definitions

## Severance Pay – Two-Times/Two-Year Exception; Limited Payments Exception (cont'd.)

- Stacking of exemptions
  - Short-term deferral exception, two-times/two year exception, and other limited payments exception can be stacked
  
- “Limited Payments” exception exempts payments under a separation pay plan to the extent they do not exceed Section 402(g)(1)(b) limit (\$16,500 for 2011)



## Releases

- Severance or other payments conditioned upon delivery of a release of claims can result in 409A violation unless timing of delivery of release is properly structured
- Design alternatives for payments conditioned on delivery of release include:
  - Require delivery of release within 90 days (or shorter period) after severance or other payment trigger (potential payment period cannot exceed 90 days). If potential payment period straddles tax years, payment must be made in later year
  - Provide for payment on (or commencing on) a specified date that occurs on or after the release delivery deadline

## Substitutions

- Payment of an amount in substitution for deferred compensation is treated as payment of deferred compensation which can result in an impermissible acceleration or deferral
- Whether a payment is a substitute for a payment of deferred compensation depends on the facts and circumstances
- Regulations provide that creation of a new right to a payment proximate to the forfeiture of a right to deferred compensation is presumed to be a substitute for deferred compensation. Treas. Reg. § 1.409A-3(f)

## Golden Parachute Caps and Gross-Ups

- Caps
  - Specify order in which payments/benefits will be reduced if cap may apply to Section 409A deferred compensation
  
- Gross-Ups
  - Treated as being paid at a specified time or on a fixed schedule if gross-up required to be paid (and is paid) by end of service provider's tax year following the tax year in which service provider remits the taxes
  - Similar rule for tax audit or tax litigation expenses

## Termination and Liquidation of Deferred Compensation Plans

- Plan may provide for acceleration of payment (or service recipient discretion to accelerate payment) upon termination or liquidation of plan. Treas. Reg. §§ 1.409A-3(j)(4)(i) and (ix)
  - Must terminate and liquidate all plans sponsored by service recipient that would be aggregated with the terminated plan if the service provider had deferrals under all such plans
  - Termination not proximate to a downturn in the financial health of service recipient
  - Service provider cannot have discretion as to whether payment will be accelerated or a direct or indirect election as to whether payment will be accelerated (determined based on facts and circumstances)

## Termination and Liquidation of Deferred Compensation Plans (cont'd)

- Plan need not provide for termination/liquidation payments
- IRS/ABA Q&A's: Plan terms requiring participant consent for termination provides impermissible election. See American Bar Association, Section of Taxation, May Meeting 2010, Q&A-26
- Generally advisable to include in plan document unilateral right for service recipient to terminate plan

## Accelerated Payments — Limited Cashouts

- Allows cashouts up to Section 402(g) limit (\$16,500 for 2011). Treas. Reg. § 1.409A-3(j)(4)(i) and (v)
- Plan terms must include (or be amended to include) a limited cashout provision if limited cashouts are to be made
- Cashout must be lump sum of entire plan benefit (plan aggregation rules apply)
- No service provider discretion or direct or indirect election

## Plan Administration — Rabbi Trusts

- No funding of rabbi trust if defined benefit plan is in “at risk” status. IRC § 409A(b)(3)
- Watch for defined benefit plans at controlled group members
- “At risk”: generally less than 80% funded. IRC § 430(i)(4)
- Additional 409A rabbi trust funding restrictions in connection with (i) bankruptcy of defined benefit plan sponsor and (ii) defined benefit plan terminations. IRC § 409A(b)(3)(B)(ii) and (iii)

## Plan Administration — Maintain Inventory of Selection 409A Deferred Compensation

- Plan termination and liquidation rules: Must terminate all plans of same type. Treas. Reg. § 1.409A-3(j)(4)(ix)(C)
- Document correction program: Must correct all plans with similar failures. Notice 2010-6, § III.B.
- Future W-2 Code Y reporting of deferrals. Notice 2008-115, § III.A.
- All of a service recipient's plans must use the same specified employee identification rules for applying the six-month delay (applicable to public companies). Treas. Reg. § 1.409-1(i)



## Administration — Don't Forget FICA Taxes on Deferred Compensation

- Special FICA Deferred Compensation Rules. IRC § 3121(v).
  - FICA generally imposed upon vesting of deferred compensation. Treas. Reg. § 3121(v)(2)-1(a)(2)(ii)
  - Special rules for nonaccount balance plans — when amount is reasonably ascertainable. Treas. Reg. § 3121(v)(2)-1(e)(4)(i)(A)
  - Result: FICA taxes generally due before deferred compensation is actually paid
- Accelerated Distribution Permitted to Pay FICA Taxes. Treas. Reg. § 1.409A-3(j)(4)(vi).
  - Accelerated distributions permitted for income tax withholding on distribution for FICA taxes. Treas. Reg. § 1.409A-3(j)(4)(vi)
  - No service provider discretion or direct or indirect election