

IRS and Treasury Clarify Certain Key Issues Under Code Section 409A

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Annually, the American Bar Association's Joint Committee on Employee Benefits (JCEB) organizes a conference with IRS and Treasury officials to present written questions and proposed responses for reaction from the government panelists. Although the government's responses to these interpretive and practical questions do not constitute official guidance and cannot be relied upon, this year's responses to questions posed by Skadden, Arps and other practitioners help clarify the government's position on some of the difficult questions that remain unanswered by the Treasury regulations under Internal Revenue Code Section 409A (409A) relating to taxation of nonqualified deferred compensation arrangements.

The 2009 JCEBs with the IRS and Treasury were published on September 17, 2009. Some of the more significant government responses to questions relating to 409A are set forth below.

Acceleration of Payments Based on Type of Employment Termination. Some practitioners believed that if a plan provides for payment of vested deferred compensation on a fixed date, 409A prohibits accelerated distribution of the benefit upon a particular type of termination of employment such as involuntary termination. This is because 409A (with some exceptions) only permits one time and form of payment for any one type of payment trigger, such as employment termination (the so-called "anti-toggling rule"). Thus there was concern that a plan providing for early distribution on an involuntary termination but for a later distribution (on the original fixed payment date) in the event of other types of termination, violated the anti-toggling rule.

In response to a question posed by Skadden, Arps, the IRS and Treasury have very helpfully resolved this question and indicated it is permissible for a plan that otherwise pays benefits on a fixed payment date to provide for earlier payment upon only one type of a termination. For example, a plan may distinguish between an involuntary termination, in which case the payment is made upon termination, and a voluntary termination, in which case the payment is made on the originally scheduled fixed date. It is also interesting that while the IRS and Treasury cautioned that whether there has been an involuntary separation from service must be objectively determinable and nondiscretionary, it did not state that the involuntary termination must be a termination considered "involuntary" under the complicated 409A regulations on this issue. It is thus apparently possible to use a broader (objective) definition of involuntary termination of employment to trigger early payment. The question also leaves open the possibility of distinguishing among other types of terminations of employment (*e.g.*, terminations before and after a specified event), as long as the distinctions are objective and nondiscretionary.

Change in Form of Payment From Cash to Restricted Stock. Skadden, Arps also posed a question as to whether an employer or employee could change the form of payment of deferred compensation from cash to restricted stock after the deadline for making the initial deferral election and without regard to the 409A

subsequent election timing rules. Skadden, Arps argued that the change in form of payment should not be subject to the rules governing subsequent deferral elections, because the transfer of restricted property does not constitute deferred compensation under 409A. However, the IRS and Treasury representatives declined to agree or disagree, stating that the issue is under study at the IRS and Treasury. Accordingly, until further guidance is issued, companies should be cautious when changing payment of deferred compensation from cash to restricted stock, even when the change is not motivated by a desire to defer income.

Plan Termination — Meaning of “Downturn in Financial Health.” Generally, 409A permits a plan sponsor to terminate a nonqualified deferred compensation plan and distribute the plan benefits if certain conditions are met. One of the conditions is that plan termination is not “proximate to a downturn in the financial health” of the plan sponsor. Due to the current general economic downturn, it is of much practical interest to understand what circumstances will be viewed as a downturn in the financial health of the plan sponsor that would prevent it from terminating its nonqualified arrangements in compliance with 409A. The IRS and Treasury was asked to confirm that poor economic conditions generally, without more, do not constitute a downturn in the financial health of the plan sponsor, whereas objective knowledge that bankruptcy is imminent could bar the plan sponsor from making payments pursuant to a termination and liquidation of the plan. The IRS and Treasury representatives responded that there is no bright-line test and the question must be determined based on applicable facts and circumstances. In particular, IRS and Treasury cautioned that insolvency or bankruptcy does not have to be imminent in order to have a “downturn in the financial health.”

Separation Pay Exception Can Apply to Double Trigger Severance. Subject to certain limitations on amount and payment period, payments that can be made “only upon an involuntary separation from service” are exempt from application of 409A (the “separation pay plan exception”). Some practitioners were concerned that this separation pay plan exception would not be applicable to a so-called “double trigger” arrangement (*i.e.*, one under which payment is made only on an involuntary termination of employment following a change in control). The IRS and Treasury helpfully clarified that the 409A exception for a separation pay plan applies even when an additional trigger is required in connection with the payment of severance, agreeing that, so long as no payment will be made in any case where the employee does not incur an involuntary termination of employment, the exception will apply.

Short-Term Deferral Exception. The 2009 JCEBs confirm that if a payment is a short-term deferral and therefore exempt from 409A, the parties may adjust the amount and timing of payment, so long as the modified arrangement still qualifies as a short-term deferral. The IRS and Treasury representatives cautioned that the concept of constructive receipt still applies. Although not mentioned, it is important to keep in mind that the prohibition under 409A on extension of substantial risk of forfeiture will also significantly limit taxpayer’s ability to change payment terms of short-term deferrals.

A full-text version of the 2009 JCEBs can be accessed at <http://www.abanet.org/jceb/2009/IRS2009.pdf>. It is important to keep in mind that the guidance provided under the 2009 JCEBs, while helpful, is not binding on the IRS, Treasury or any taxpayer. We strongly recommend that companies seek the advice of legal counsel in connection with any questions regarding the potential application of 409A and the IRS guidance described above to their nonqualified deferred compensation plans or arrangements.