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I.R.C. § 409A AND THE SMALL BUSINESS

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I. INTRODUCTION

The general public may think nonqualified deferred compensation involves only large corporations who simply cannot find enough ways to give their executives more money in a favorable tax manner. However, the reach of § 409A is far and wide. As a result, many ordinary business planning agreements often not thought to be nonqualified deferred compensation are swept up in § 409A's broad net.¹

This article is designed to do two things. First, this article recounts the development of I.R.C. § 409A and its regulations. This article briefly describes what led to § 409A, how § 409A changed prior law, and the current status of nonqualified deferred compensation.

Second, this article identifies several business succession planning techniques that give rise to § 409A issues. This article develops a hypothetical example to show how these techniques might be used in small business succession planning and the § 409A implications of each technique. Given that nonqualified deferred compensation is usually thought of as involving only large corporations, many traps for the unwary exist when dealing with closely-held corporations.

This article begins with a short historical account of the enactment of I.R.C. § 409A. In Part II, this article continues with a summary of the major changes to nonqualified deferred compensation as a result of I.R.C. § 409A.

In Part III, this article discusses recent guidance on I.R.C. § 409A including I.R.S. Notice 2008-113,² I.R.S. Notice 2008-115,³ and Proposed

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¹ See I.R.S. Notice 2005-1, 2005-2 I.R.B. 274 ("The application of § 409A is not limited to arrangements between an employer and an employee. For example, § 409A may apply to arrangements between a service recipient and an independent contractor, or arrangements between a partner and a partnership . . .").

² 2008-51 I.R.B. 1305.

Treasury Regulation § 1.409A-4.⁴ Even with the final regulations becoming effective for taxable years beginning after December 31, 2008,⁵ the work on § 409A guidance is not complete. Proposed Treasury Regulation § 1.409A-4 fills in one missing part by providing administrative guidance on determining the amounts includible when a plan fails to meet the requirements of I.R.C. § 409A.⁶

Still unknown is whether additional guidance will be issued regarding the applicability of § 409A to partners and partnerships. As provided in I.R.S. Notice 2005-1 and in the preamble to the final regulations, until further notice, taxpayers may treat the issuance of an interest in a partnership the same as an issuance of stock.⁷

In Part IV, this article discusses planning opportunities that are available for small businesses using nonqualified deferred compensation. Generally, closely-held businesses are formed as an S Corporation, a partnership, or a limited liability company electing to be taxed as a partnership. As such, these small businesses have pass-through taxation.⁸ Often, the effect of pass-through taxation is that no tax benefit can be realized by a nonqualified deferral of compensation because the employee participating in the nonqualified deferral plan is also an owner of the business.⁹ Part IV of this article also explores several business planning

³ 2008-52 I.R.B. 1367.

⁴ 73 Fed. Reg. 74,380 (Dec. 8, 2008).

⁵ See I.R.S. Notice 2007-86, 2007-46 I.R.B. 990.

⁶ See Prop. Treas. Reg. § 1.409A-4, 73 Fed. Reg. 74,380, 74,381 (Dec. 8, 2008) (“These proposed regulations address the calculation of amounts includible in income under section 409(A)(a), and related issues including the calculation of the additional taxes applicable to such income. Section 409(A)(a) generally provides that amounts deferred under a nonqualified deferred compensation plan in all years are includible in income unless certain requirements are met.”).

⁷ I.R.S. Notice 2005-1, 2005-2 I.R.B. 274; Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, 19,243 (Apr. 17, 2007).

⁸ See I.R.C. § 701 (2006) (partnerships); *id.* § 1366 (S corporations); see also Richard Winchester, *Working for Free: It Ought to be Against the (Tax) Law*, 76 Miss. L.J. 227, 241–42 (2006).

⁹ *Cf.* MICHAEL G. GOLDSTEIN ET AL., TAXATION AND FUNDING OF NONQUALIFIED DEFERRED COMPENSATION 213–14 (1998) (neither a partnership’s partners nor an S Corporation’s shareholders realize tax deferral under I.R.C. § 404(a)(5)).

techniques in which I.R.C. § 409A could have an impact on succession planning in closely-held businesses.

Finally, in Part V, this article explores a hypothetical example to show how § 409A is applicable and what considerations should be addressed by the client's advisors.

A. Overview

1. Before § 409A

In a nonqualified deferred compensation agreement, an employer and an employee agree that income earned by the employee in the current taxable year will be deferred to a future taxable year.¹⁰ Prior to § 409A, an employer would credit an employee's "account" with earnings or losses based upon some predetermined index. To avoid the deferred compensation being includible in the employee's gross income under the constructive receipt doctrine,¹¹ the employee only has the employer's unsecured promise to pay in the future.¹² This arrangement is advantageous to the employee because the employee delayed the receipt of income and thus delayed the paying of taxes unless there is a substantial risk of forfeiture (other than FICA taxes) related to that income.¹³ To avoid the requirements of ERISA, nonqualified deferred compensation plans may only be made available to a "select group of management or highly compensated employees."¹⁴

¹⁰ Section 409A does not apply to certain deferred compensation agreements. *See* § 409A(d)(1)–(2). For example, sick leave, disability pay, and certain pensions are excluded. *Id.*

¹¹ The constructive receipt doctrine is discussed in Treasury Regulation § 1.451-2 (as amended in 1979).

¹² *Cf.* I.R.C. § 83 (2006) (requiring that property be subject to a substantial risk of forfeiture in order for the tax consequences to be deferred).

¹³ Prop. Treas. Reg. § 1.409A-1, 70 Fed. Reg. 57,930, 57,930 (Oct. 4, 2005) (citing Treasury Regulation § 3121(v)(2) and its special timing rule concerning FICA taxes).

¹⁴ 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1) (2006).

2. *The Enactment of § 409A*

In February 2002, the Senate Finance Committee directed the Joint Committee on Taxation to investigate Enron.¹⁵ The Joint Committee's report totaled 723 pages (not including the four appendices) detailing many of the abuses at Enron, including those involving nonqualified deferred compensation.¹⁶

Building upon the Joint Committee's Report, in October 2004, Congress enacted the American Jobs Creation Act of 2004.¹⁷ Among its provisions was the creation of a new section of the Internal Revenue Code.¹⁸ I.R.C. § 409A added very detailed requirements for nonqualified deferred compensation plans. Both initial and subsequent elections to defer compensation must be made at very specific times.¹⁹ A narrow list of permissible triggers for payment is given.²⁰ If a plan fails to comply with § 409A, then there are severe income tax consequences including inclusion of the deferred compensation in income with interest at the underpayment rate plus an additional 1 percent, and a 20 percent penalty based upon the now includable amount.²¹

In Autumn 2005, the Treasury Department issued Proposed Regulations for § 409A.²² On April 17, 2007, the Treasury Department issued final regulations.²³ Including its Preamble, the final regulations as

¹⁵ STAFF OF JOINT COMM. ON TAX'N, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, VOLUME I: REPORT, at 1 (Comm. Print 2003), *available at* www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html. Enron filed for bankruptcy protection on December 2, 2001 (Case 01-16034, S.D. New York).

¹⁶ *Id.* at 14.

¹⁷ See American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (codified as amended in scattered sections of 26 U.S.C.).

¹⁸ *Id.* § 885.

¹⁹ See I.R.C. § 409A(a) (2006).

²⁰ *Id.* § 409A(a)(2)(A) (requiring distributions from nonqualified deferred compensation plans be made no earlier than "separation from service," date of disability, "death," a predetermined date, change in ownership, or "an unforeseeable emergency").

²¹ *Id.* § 409A(a)(1).

²² Prop. Treas. Reg. § 1.409A-1, 70 Fed. Reg. 57,930, 57,930 (Oct. 4, 2005).

²³ Treas. Reg. §§ 1.409A-0, -1, -2, -3, -6 (2007).

formatted in the Treasury's press release run 397 pages²⁴ and still have sections reserved for future guidance.²⁵ The final regulations were to be applicable to taxable years beginning on or after January 1, 2008.²⁶ A major requirement of the regulations was that all nonqualified deferred compensation plans needed to be in written compliance on or before December 31, 2007.²⁷

Faced with the task of reviewing and amending existing nonqualified deferred compensation plans, not to mention identifying other arrangements that are not thought of as nonqualified deferred compensation, for example, covenants not to compete,²⁸ that are now within § 409A's parameters, practitioners across the country loudly and in great numbers requested relief.²⁹ On November 13, 2007, the Service responded to practitioners' complaints and issued I.R.S. Notice 2007-86³⁰ extending the effective date of the final regulations until January 1, 2009.³¹ The reprieve was welcomed.³²

Despite the delay of the application of the final regulations, nonqualified deferred compensation plans still needed to be operated in compliance with § 409A for deferrals made for taxable years beginning on or after January 1, 2005.³³ For deferrals made prior to January 1, 2005, I.R.C. § 409A is only applicable if the nonqualified deferred compensation plan is materially modified after October 3, 2004.³⁴

²⁴ In the Code of Federal Regulations, the final regulations, formatted as single-spaced and in double columns, run 86 pages. *Id.*

²⁵ *Id.* § 1.409A-0 (listing § 1.409A-4 and § 1.409A-5 as reserved).

²⁶ *Id.* § 1.409A-6(b).

²⁷ *Id.* § 1.409A-1(c)(3)(vii).

²⁸ See Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, 19,236 (Apr. 17, 2007).

²⁹ See *id.* at 19,234–76 (discussing and explaining concerns of commentators on I.R.C. § 409A and its proposed regulations).

³⁰ 2007-46 I.R.B. 990 (Nov. 13, 2007).

³¹ *Id.*

³² See, e.g., Michael Doran, *Time to Start Over on Deferred Compensation*, 28 VA. TAX REV. 223, 233 (2008).

³³ See I.R.S. Notice 2005-1, 2005-2 I.R.B. 274.

³⁴ Treas. Reg. § 1.409A-6(a)(1)(i) (2007).

II. CHANGES REQUIRED BY I.R.C. § 409A

I.R.C. § 409A has undoubtedly impacted nonqualified deferred compensation.³⁵ Most dramatically, what is lost by taxpayers is the ability of an employee and employer to renegotiate the terms of the nonqualified deferred compensation agreement at any time prior to the nonqualified deferred compensation being payable to the employee.³⁶ Much of the flexibility that once existed³⁷ is now lost. All hope, however, has not vanished. Many planning opportunities still exist but careful attention to details must be given to avoid harsh adverse tax consequences. With careful planning nonqualified deferred compensation is still a valuable tool to compensate and retain key employees.

This section provides a basic overview of § 409A, including how it differs from prior law.

³⁵ A nonqualified deferred compensation plan “provides for the deferral of compensation, other than [in] a qualified employer plan, and [other than in] any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. I.R.C. § 409A(d)(1) (2006). To avoid ERISA complications, nonqualified deferred compensation may be offered only to a “select group of management or highly compensated employees.” See Michael G. Goldstein, William A. Drennan & Michael J. Hussey, *Use of Life Insurance in Nonqualified Deferred Compensation Planning*, 29 EST. PLAN. Jan. 2002, at 13–14 (analyzing *Miller v. Heller*, 915 F. Supp. 651 (S.D.N.Y. 1996)). In any closely-held business, a determination will have to be made whether those participating in the nonqualified deferred compensation plan are members of a “select group of management or highly compensated employees.” See *id.* This requirement is known as the “top hat” provision and is necessary to avoid the application of ERISA’s requirements, including ERISA’s participation requirement. *Id.*

³⁶ See Michael J. Hussey, *Has Congress Stopped Executives From Raiding the Bank? A Critical Analysis of I.R.C. § 409A*, 75 UMKC L. REV. 437, 438 (2006) (“Congress enacted I.R.C. § 409A to restrict the contractual freedom of executives and employers to negotiate executive compensation.”).

³⁷ *Id.*

A. Initial Elections

Under prior law, an employee was not in constructive receipt of the compensation until it was payable.³⁸ This was true even if the employee had already performed the services.³⁹

Under § 409A, generally, the initial election to defer must be made before the close of the preceding taxable year.⁴⁰ For example, if an employee wishes to defer compensation for services performed in 2009, a deferral election must have been made on or before December 31, 2008. I.R.C. § 409A does provide an exception if the current taxable year is the first year in which an employee is eligible to participate in the nonqualified deferred compensation plan.⁴¹ In this case, the employee must make the initial election within 30 days of becoming eligible to participate.⁴² For example, suppose an employee is hired by an employer on June 1, 2009. As a result of the employee's hiring, he or she is eligible to participate in a nonqualified deferred compensation plan offered by the employer. Under § 409A, if the employee wishes to participate for 2009, the employee must make the election on or before July 1, 2009, which is 30 days after the June 1, 2009 eligibility date.

I.R.C. § 409A provides another exception when the compensation being deferred is performance-based.⁴³ If the compensation is based on performance over a 12 month period, then the initial election must be made no later than 6 months before the end of the period.⁴⁴ For example, if an employee is to be paid a bonus of 5 percent of the company's profits for the 2009 calendar year, then the employee must make the election to defer on or before June 30, 2009.

³⁸ *Cf. id.*, at 452 ("For the constructive receipt doctrine to apply, the taxpayer must have a right to receive the income and there must not be any substantial limitations or restrictions on that right.") (citing Treasury Regulation § 1.451-2(a) (as amended in 1979)).

³⁹ *See, e.g., Veit v. Comm'r*, 8 T.C. 809, 815-16 (1947); *Veit v. Comm'r*, 8 T.C.M. 919 (1949).

⁴⁰ I.R.C. § 409A(a)(4)(B)(i).

⁴¹ *Id.* § 409A(a)(4)(B)(ii).

⁴² *Id.*

⁴³ *See id.* § 409A(a)(4)(B)(iii). The regulations define "performance-based" as compensation "contingent on the satisfaction of preestablished organizational or individual performance criteria" over a 12 month period. Treas. Reg. § 1.409A-1(e) (2007).

⁴⁴ I.R.C. § 409A(a)(4)(B)(iii).

1. Subsequent Elections

Under prior law, generally an employee and an employer were able to renegotiate the payment of the nonqualified deferred compensation at any time prior to the date the amount was payable without causing the employee to be in constructive receipt of the deferred amounts.⁴⁵ For example, if a nonqualified deferred compensation plan provided that a participant was to receive a payment on July 1, the participant and employer could renegotiate the payment date through June 30. The participant was not in constructive receipt of the deferred payment because the payment was not due until July 1 even if the employer was able to pay the deferred amount earlier.

I.R.C. § 409A provides a very detailed structure for permissible subsequent deferrals.⁴⁶ There are three separate requirements that must be met in order for the subsequent deferral to be respected for § 409A purposes. First, a subsequent election to further postpone payment of nonqualified deferred compensation must be made 12 months before the compensation is payable.⁴⁷ Second, the “election may not take effect until at least 12 months after the date on which the election is made.”⁴⁸ Finally, any amount to be postponed must be deferred at least “5 years from the date such payment would otherwise have been made.”⁴⁹

Further, if the nonqualified deferred compensation plan is not carefully drafted, what might otherwise appear as a series of separate payments will be treated as one payment and the ability to defer will be lost when the first payment is due within 12 months.⁵⁰ For example, if the nonqualified deferred compensation plan provides for 3 annual payments beginning on June 1, 2010, as of June 1, 2009, it will no longer be possible to defer any of the payments if they are determined to be one payment and not three separate payments. To avoid this result, the nonqualified deferred

⁴⁵ See, e.g., *Veit v. Comm’r*, 8 T.C. 809, 815–16 (1947); *Veit v. Comm’r*, 8 T.C.M. 919 (1949).

⁴⁶ I.R.C. § 409A(a)(4)(C).

⁴⁷ *Id.* § 409A(a)(4)(C)(iii).

⁴⁸ *Id.* § 409A(a)(4)(C)(i).

⁴⁹ *Id.* § 409A(a)(4)(C)(ii). This final requirement does not apply to plans triggered by disability, death, or unforeseeable emergencies. *Id.*

⁵⁰ See Treas. Reg. § 1.409A-2(b)(2)(iii) (2007).

compensation plan should expressly provide that each annual payment is a separate payment.⁵¹

2. *Changes in Triggering Events*

a. *Overview*

Prior law generally permitted payment triggers that did not violate the constructive receipt doctrine.⁵² For example, a plan could provide that the employer would pay the benefits when an employee switched from full-time to part-time employment.⁵³ I.R.C. § 409A lists exclusive triggers for payment of nonqualified deferred compensation.⁵⁴ A nonqualified deferred compensation plan having triggers other than those permitted in § 409A will cause the participant to be in constructive receipt of all deferred amounts.⁵⁵ The permitted triggers are: “separation from service,” disability, “death, a specified time,” change of control, and “an unforeseeable emergency.”⁵⁶ With the exception of death, the permitted triggers are all defined in § 409A.⁵⁷ As a result, triggers in an existing plan might not meet § 409A’s requirements, thus disqualifying the plan. For example, a nonqualified deferred compensation plan providing for a distribution upon a participant’s disability as determined under the employer’s insurance plan may not meet § 409A’s requirements unless the definition in the insurance plan matches § 409A’s definition.⁵⁸ Given the particularity of I.R.C. § 409A’s definition, it is unlikely that any insurance plan offered by an employer contains a definition of disability that meets § 409A’s requirements.

⁵¹ *Id.*

⁵² *See, e.g.*, Rev. Rul. 60-31, 1960-1 C.B. 174.

⁵³ *Id.*

⁵⁴ *See* I.R.C. § 409A(a)(2)(A).

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.* § 409A(a)(2)(B)–(C). “Separation from service” is further defined in the regulations. *See* Treas. Reg. § 1.409A-1(h) (2007).

⁵⁸ One permissible trigger for disability is “receiving income replacement benefits for a period of not less than 3 months.” I.R.C. § 409A(a)(2)(C)(ii). The definition in the employer’s plan could never match § 409A’s definition because the employee would have to be receiving the income replacement benefits in order to start receiving the nonqualified deferred compensation plan benefits. For more, see Section 2c below discussing I.R.C. § 409A’s disability trigger.

b. Unforeseeable Emergencies

Prior law had no definition of “unforeseeable emergency” for purposes of distributions from a nonqualified deferred compensation plan.⁵⁹ Therefore, under prior law, if a nonqualified deferred compensation plan allowed for a hardship distribution, such a distribution could be made if approved by the plan administrator.

I.R.C. § 409A permits “the occurrence of an unforeseeable emergency” to be a triggering event allowing a payment from a nonqualified deferred compensation plan.⁶⁰ The regulations provide that an unforeseeable emergency includes an “illness or accident” to the participant, his or her spouse, beneficiary, or dependent.⁶¹ An unforeseeable emergency also includes a loss of property due to casualty and “other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider.”⁶² Whether an emergency is unforeseeable is a facts and circumstances test.⁶³

The regulations provide examples of events that are likely unforeseeable emergencies.⁶⁴ The Regulations do not go so far as to provide that these events are presumed to be unforeseeable or that these

⁵⁹ In 1992, the IRS provided guidance on when the Service would issue a ruling on whether the constructive receipt doctrine was applicable. Rev. Proc. 92-65, 1992-33 I.R.B. 16. To be eligible to request a ruling, a nonqualified deferred compensation plan had to meet several requirements. *Id.* Plans were permitted to allow distributions for an “unforeseeable emergency” but the plan had to define such an emergency as “an unanticipated emergency that is caused by an event beyond the control of the participant or beneficiary and that would result in severe financial hardship to the individual if early withdrawal were not permitted.” *Id.* The plan had to further limit the amount of the emergency withdrawal to the amount needed to alleviate the unforeseen emergency. *Id.* Having a different definition of unforeseen emergency did not necessarily mean that the employee was in constructive receipt of the deferred compensation. Revenue Procedure 92-65 simply provides that the Service will not issue a private letter ruling if the plan does not contain the Procedure’s definition of “unforeseeable emergency.” *Id.*

⁶⁰ See I.R.C. § 409A(a)(2)(A)(vi).

⁶¹ Treas. Reg. § 1.409A-3(i)(3)(i) (2007).

⁶² *Id.*

⁶³ *Id.*

⁶⁴ See *id.*

events constitute any safe harbor for unforeseeability.⁶⁵ Examples of likely unforeseeable events include “the imminent foreclosure of or eviction from the employee’s primary residence,” medical expenses, and “the funeral expenses of a spouse, a beneficiary, or a dependent.”⁶⁶ The regulations also provide two examples of events that are likely not unforeseeable but again stop short of saying that these events are unforeseeable.⁶⁷ These likely not unforeseeable emergencies are a purchase of a home and the payment of college tuition.⁶⁸

The Regulations severely limit the amounts that may be distributed to an employee as a result of an unforeseeable emergency. First, the distribution can only be made to the extent that the employee does not have other resources from which the needs of the unforeseeable emergency could be met.⁶⁹ The Regulations provide that if the employee will be reimbursed or compensated by insurance, then a distribution cannot be made from the nonqualified deferred compensation plan.⁷⁰ If the employee is able to sell assets to meet the need, and the sale of the employee’s assets does not cause a financial hardship, then a distribution cannot be made.⁷¹ Also, if cessation of the employee’s deferrals to the nonqualified deferred compensation plan would alleviate the needs of the unforeseeable emergency, then a distribution cannot be made.⁷² Assuming that the employee does not have other resources from which the needs of the unforeseeable emergency can be met, the distribution is “limited to the amount reasonably necessary” to alleviate the unforeseeable emergency and any taxes due as a result of the distribution.⁷³

c. Disability

Prior law, as noted above, contained no provision for when a nonqualified deferred compensation plan payment could be triggered. As

⁶⁵ See *id.* (repeated use of the qualifier “may” coupled with the facts and circumstances test).

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ See *id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.* § 1.409A-3(i)(3)(ii).

such, there was no provision defining when an employee had become disabled for nonqualified deferred compensation purposes. In Revenue Ruling 60-31, the Service provided that a distribution could be made from a nonqualified deferred compensation plan upon disability, but the Revenue Ruling did not provide a definition of disability.⁷⁴

Under I.R.C. § 409A, an employee is considered disabled for § 409A purposes when either of two tests are met. First, if the employee “is unable to engage in any substantial gainful activity” because of an impairment which is expected to result in death or last for not less than 12 consecutive months, then the employee is considered disabled and may receive a distribution from a nonqualified deferred compensation plan.⁷⁵ Second, if the employee, for not less than 3 months, has been receiving income replacement benefits as a result of an impairment which is expected to result in death or last for not less than 12 consecutive months, then the employee is considered disabled for § 409A and may receive a distribution from a nonqualified deferred compensation plan.⁷⁶

The definition of disability in § 409A is likely more restrictive than definitions contained in both existing nonqualified deferred compensation plans and disability insurance policies. Under § 409A’s first test, an employee can be considered disabled only if he or she is not able to engage in “any substantial gainful activity.”⁷⁷ If an employee suffers some event that causes the employee not to be able to work at the same level but is still able to engage in some activity, the employee would not be considered disabled for § 409A purposes even though the employee’s ability to work is sharply reduced from previous levels. If the employee is unable to meet the first test, then under § 409A’s second test, the employee must receive income replacement benefits for at least 3 months before being eligible for a distribution from a nonqualified deferred compensation plan that is triggered by the employee’s disability.⁷⁸ Under these circumstances, an employee who is able to engage in substantial gainful activity would have to wait at least three months before receiving nonqualified deferred compensation plan payments, a requirement that could prove burdensome.

⁷⁴ See Rev. Rul. 60-31, 1960-1 C.B. 174.

⁷⁵ I.R.C. § 409A(a)(2)(C)(i) (2006).

⁷⁶ *Id.* § 409A(a)(2)(C)(ii).

⁷⁷ *Id.* § 409A(a)(2)(C)(i).

⁷⁸ *Id.* § 409(A)(a)(2)(C)(ii).

d. Separation from Service

In Rev. Rul. 60-31, the Service discussed two scenarios involving nonqualified deferred compensation plans.⁷⁹ In each scenario, a permissible trigger was the employee's separation from service.⁸⁰ The first scenario contained two relevant triggers. The first trigger was "termination of the taxpayer's employment by the corporation."⁸¹ The second trigger was "the taxpayer's becoming a part-time employee of the corporation."⁸² In the Revenue Ruling's second scenario, the relevant trigger was when the employee "is no longer employed by the company."⁸³ The Service did not give any further guidance as to what precisely constituted termination of employment or what constituted part-time employment.⁸⁴ In each scenario, the Service concluded that the employee was not in constructive receipt of the amounts deferred.⁸⁵

Prior law, as noted above, contained no provision for when a nonqualified deferred compensation plan payment could be triggered. As such, there was no provision defining when an employee had "separated from service" for nonqualified deferred compensation purposes.

Under § 409A and its regulations, an employee is treated as having been separated from service if there is a termination of employment as determined by a facts and circumstances test.⁸⁶ The underlying question is whether "the employer and employee reasonably anticipate[] that no further services [will] be performed."⁸⁷ The facts and circumstances determination is made at the time of the putative separation from service.⁸⁸ If the parties reasonably anticipated at the time of separation that the employee's employment would be terminated or would be "no more than 20 percent of the average level of bona fide services performed" over the preceding 36 months, then a separation from service for § 409A purposes

⁷⁹ See Rev. Rul. 60-31, 1960-1 C.B. 174.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ See *id.*

⁸⁵ *Id.*

⁸⁶ Treas. Reg. § 1.409A-1(h)(1)(ii) (2007).

⁸⁷ *Id.*

⁸⁸ See *id.*

has occurred even if the employee later returns to work for the employer.⁸⁹ For example, Ernie is an employee of Acme, Inc. On April 1, Ernie terminates his employment as CEO of Acme, Inc. Ernie is not anticipating returning to employment with Acme, Inc. Acme, Inc. hires Frank to be the new CEO. On August 1, Frank abruptly quits. Acme's board of directors approaches Ernie about returning to full-time employment with Acme as its interim CEO while a search is conducted for a new CEO. Ernie agrees. Ernie has separated from service for § 409A purposes on April 1 because Ernie and Acme reasonably anticipated that Ernie's employment with Acme would be terminated. The fact that Ernie returned to employment with Acme is not taken into account for § 409A purposes because the parties did not reasonably anticipate that Ernie would return to employment. Nothing in this example suggests that Ernie and Acme could have reasonably anticipated Frank's abrupt quitting.

To assist taxpayers, the § 409A regulations provide a safe harbor for determining when an employee has separated from service for § 409A purposes. If the "level of bona fide services" performed after the termination date is no more than 20 percent of the level of services performed in the preceding 36 month period then the employee will be presumed to have separated from service for § 409A purposes.⁹⁰ Returning to the above example, assume that on April 1 Ernie ceases to be CEO of Acme. Further assume that as CEO, Ernie worked 60 hours per week for the last 36 months. On April 1, Ernie and Acme agree that Ernie will continue to be available to Acme for consulting for 10 hours per week. Nothing indicates that Ernie will be required to work more than 10 hours per week. Ernie falls within the safe harbor and has separated from service for § 409A purposes because Ernie and Acme reasonably anticipate on the date of Ernie's termination as CEO that Ernie's continued services for Acme will be below 20 percent of the level of his previous services.

The § 409A regulations also provide a rebuttable presumption that there has been no separation from service if the level of services performed after the termination date is 50 percent or more of the level of services performed in the preceding 36 month period.⁹¹

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

No presumption applies for a post-termination date level of service that is more than 20 percent but less than 50 percent.⁹² Returning to the above example, assume that Ernie ceases to be CEO of Acme on April 1. Further assume that as CEO, Ernie worked 60 hours per week for the last 36 months. On April 1, Ernie and Acme agree that Ernie will continue to be available to Acme for consulting for 20 hours per week. Whether Ernie will have separated from service for § 409A purposes is determined by a facts and circumstances test.⁹³ No presumption applies because it is reasonably anticipated by Ernie and Acme that Ernie's employment will continue at 33 percent of his previous level. In this situation, the regulations permit Ernie and Acme to agree that upon a percentage that will be a separation of service provided certain requirements are met. If, prior to Ernie's separation from service, the nonqualified deferred compensation plan provides in writing a specific percentage greater than 20 percent and less than 50 percent, then the specified percentage will determine whether there is a separation from service.⁹⁴ Thus, if Ernie and Acme agreed in the plan that less than 40 percent was a separation from service, then Ernie's reduction to 33 percent of his previous level would be a separation from service.⁹⁵

3. *Changes in Control*

Prior law, as noted above, contained no provision for when a nonqualified deferred compensation plan payment could be triggered. As such, there was no definition of "change of control" for nonqualified deferred compensation purposes.⁹⁶

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ The specified percentage, once established, may only be changed subject to the same rules as for delaying or accelerating other payments. *Id.*

⁹⁶ In a 1992 Revenue Procedure the Service sets forth model rabbi trust provisions. Rev. Proc. 92-64, 1992-2 C.B. 422. The model trust provisions permit the payment of nonqualified deferred compensation upon a change of control. *Id.* The Revenue Procedure requires an objective definition of "change of control" and suggests the following:

the purchase or other acquisition by any person, entity or group of persons, within the meaning of section 13(d) or 14(d) of the Securities Exchange Act of 1934 ("Act"), or any comparable successor provisions,

(continued)

For § 409A purposes, a change in control of the corporation occurs if there is a change in ownership, a change in effective control, or a change in ownership of a substantial portion of the corporation's assets.⁹⁷

A change in ownership occurs if a person, or several persons acting as a group, acquire an ownership interest that "constitutes more than 50 percent of the total fair market value or total voting power of the stock of [a] corporation."⁹⁸ For example, Abe owns all 100 outstanding shares of Acme, Inc. Abe sells 60 shares to Bill. A change of control has occurred for § 409A purposes. Returning to the original example, Abe owns all 100 outstanding shares of Acme, Inc. Bill and Cora own all of the stock of Beta, Inc. Bill, Cora, and Beta, Inc. each purchase 20 shares of Acme, Inc. stock from Abe. A change in control has occurred because Bill, Cora, and Beta, Inc. acted together to acquire more than 50 percent of the stock of Acme, Inc.

A change in effective control occurs when a person, or several persons acting as a group, acquire in a 12 month period an ownership interest that constitutes "30 percent or more of the total voting power" of the corporation.⁹⁹ For example, Abe owns all 100 outstanding shares of Acme, Inc. On March 1, Abe sells Bill 10 shares of Acme, Inc. Three months later, on June 1, Abe sells Bill 20 shares of Acme, Inc. A change in effective control has occurred because Bill has acquired 30 percent of

of beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Act) of 30 percent or more of either the outstanding shares of common stock or the combined voting power of Company's then outstanding voting securities entitled to vote generally, or the approval by the stockholders of Company of a reorganization, merger, or consolidation, in each case, with respect to which person who were stockholders of Company immediately prior to such reorganization, merger or consolidation do not, immediately thereafter, own more than 50 percent of the combined voting power entitled to vote generally in the election of directors of the reorganized, merged or consolidated Company's then outstanding securities, or a liquidation or dissolution of Company or of the sale of all or substantially all of Company's assets.

Id.

⁹⁷ Treas. Reg. § 1.409A-3(i)(5)(i).

⁹⁸ *Id.* § 1.409A-3(i)(5)(v)(A). The regulations define "persons acting as a group." *Id.* § 1.409A-3(i)(5)(v)(B).

⁹⁹ *Id.* § 1.409A-3(i)(5)(vi)(A)(I).

the total voting power of Acme, Inc. within a 12 month period. Returning to the original example, Abe owns all 100 outstanding shares of Acme, Inc. On March 1, Abe sells Bill 10 shares of Acme, Inc. Three months later, on June 1, Abe sells Bill 10 shares of Acme, Inc. On the following April 1, Abe sells Bill an additional 10 shares of Acme, Inc. Although Bill now owns 30 percent of Acme, Inc., an effective change of control has not occurred because Bill did not acquire 30 percent or more within a 12 month period. Also, a change in control, as described above, has not occurred because Bill does not own more than 50 percent of Acme, Inc.'s outstanding shares.

A change in a substantial portion of a corporation's assets occurs when a person, or several persons acting as a group,

acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition . . .) assets from the corporation that have a total gross fair market value equal to or more than 40 percent of the total gross fair market value of all of the assets of the corporation immediately before such acquisition or acquisitions.¹⁰⁰

For example, Acme, Inc. is a manufacturer. It owns the real estate on which its manufacturing facility is located. The real estate is valued at \$5,500,000 and the manufacturing equipment (not fixtures) is valued at \$2,000,000. Acme also has an inventory of widgets valued at \$2,500,000. Bill purchases the manufacturing equipment and the inventory from Acme, Inc. for \$4,500,000. A change in a substantial portion of the corporation's assets has occurred because Bill has acquired more than 40 percent of the total gross fair market value of all of Acme Inc.'s assets immediately before his acquisition.

B. Plan Failures

If a nonqualified deferred compensation plan fails to meet the requirements of § 409A or is not operated in compliance with § 409A, then all deferred amounts are immediately includible in the participant's gross

¹⁰⁰ *Id.* § 1.409A-3(i)(5)(vii)(A).

income unless the amount is subject to a substantial risk of forfeiture.¹⁰¹ The amount includible is subject to interest and penalties.¹⁰² The interest is accrued from the year of the original deferral Enron filed for bankruptcy protection on December 2, 2001 (Case 01-16034, S.D. New York).¹⁰³ The interest rate is the interest rate for underpayments plus 1 percent.¹⁰⁴ There is also a 20 percent penalty imposed on the amount includible in gross income.¹⁰⁵ The Service has recently issued guidance on remedying inadvertent plan failures and calculating the amount includible in an employee's gross income when there is a plan failure.¹⁰⁶ In order to avoid a plan failure, all nonqualified deferred compensation plan documents subject to I.R.C. §409A needed to be in written compliance with I.R.C. §409A and its regulations by January 1, 2009.¹⁰⁷

III. RECENT § 409A GUIDANCE

A. Notice 2008-113

In Notice 2008-113, the Service provided relief and guidance for nonqualified deferred compensation plans when a plan is not operated in accordance with I.R.C. § 409A.¹⁰⁸ In order to be eligible for relief under Notice 2008-113, several requirements must be met. First, the employer must take "commercially reasonable steps to avoid a recurrence of the operational failure."¹⁰⁹ Second, the IRS cannot be auditing the

¹⁰¹ I.R.C. § 409A(a)(1)(A)(i) (2006). "Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial." Treas. Reg. §1.409A-1(d)(1).

¹⁰² See I.R.C. § 409A(a)(1)(B).

¹⁰³ See *id.* § 409A(a)(1)(B)(ii).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* § 409A(a)(1)(B)(i)(II).

¹⁰⁶ See I.R.S. Notice 2008-113, 2008-51 I.R.B. 1305 (providing guidance for plan failures); I.R.S. Notice 2008-115, 2008-52 I.R.B. 1367 (providing guidance for calculating the amount includible).

¹⁰⁷ See Notice 2007-86, 2007-46 I.R.B. 990.

¹⁰⁸ I.R.S. Notice 2008-113, 2008-51 I.R.B. 1305 (incorporating and expanding upon the guidance set forth in I.R.S. Notice 2007-100, 2007-52 I.R.B. 1243).

¹⁰⁹ *Id.*

employee.¹¹⁰ If an employee is being audited already by the Service, then it is too late for relief under Notice 2008-113.

Relief is available under a number of scenarios but becomes more limited when more time has lapsed since the plan failure. The first category of relief covers all employees, including insiders.¹¹¹ If the plan failure is discovered and corrected in the same taxable year, then the employee is entitled to relief.¹¹² The notice contains an example involving an employee who elected to defer 50 percent of a \$100,000 bonus.¹¹³ The employer mistakenly deferred only 10 percent of the bonus.¹¹⁴ If the employee repays the mistakenly paid \$40,000, then the employee is entitled to full relief.¹¹⁵ The employee does not need to pay interest on the amount repaid.¹¹⁶ If the employee is an insider, then the employee must pay interest on the amount repaid.¹¹⁷ Also, if the nonqualified deferred compensation would have been available to the employee during the taxable year but “was erroneously paid or made available to the [employee] more than 30 days before” the specified payment date, then the employee is entitled to relief if he or she repays the amount in the same taxable year and then tacks the number of days the payment was erroneously paid or made available to the original payment date.¹¹⁸ For example, assume the payment is due on July 1 but the employer mistakenly pays it on April 1. On May 18 (47 days after April 1), the parties discover the mistake and the employee repays the amount on the same date. The employer cannot pay the employee again until August 17 (47 days after July 1) in order to receive the relief provided by Notice 2008-113.¹¹⁹ If the original payment date has passed, then the employee must wait the same number of days as the payment was made early before receiving the proper repayment of the nonqualified deferred compensation from the

¹¹⁰ *Id.*

¹¹¹ *See id.*

¹¹² *See id.*

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

employer.¹²⁰ For example, assume again that the payment is due on July 1 but the employer mistakenly pays it on April 1 but that the parties do not discover the mistake until July 15 at which time the employee immediately repays the amount. The payment was made 91 days early. Since the original date for payment has passed, the employer must wait 91 days (October 14) after the employee's repayment to again pay the employee the nonqualified deferred compensation and be entitled to relief under Notice 2008-113.¹²¹

The second category of relief covers situations where the failure is discovered in the year immediately following the year in which the failure occurs.¹²² Relief is only available to employees who are not insiders.¹²³ The employee must repay the amount with interest.¹²⁴ Additional time for repayment is available for employees for whom the current full repayment would cause "an immediate and heavy financial need."¹²⁵ As above, relief is also available when an amount was made available to the employee in the proper taxable year but before the date in such taxable year when the employee was entitled to the payment.¹²⁶

The third category of relief involves certain situations where the failure is discovered after the taxable year immediately following the year of the failure.¹²⁷ In these situations, only limited relief is granted taxpayers. First, the amount to be included under I.R.C. § 409A is limited to the amount erroneously paid or made available rather than all amounts deferred under the plan.¹²⁸ Second, although the 20 percent penalty is still assessed, the additional 1 percent interest rate is not charged.¹²⁹

¹²⁰ *See id.*

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *See id.*

¹²⁷ *See id.* For example, the plan failure occurs in 2009 but is discovered in 2011.

¹²⁸ *Id.*

¹²⁹ *Id.* ("[T]he service provider is . . . not required to pay the additional tax under § 409A(a)(1)(B)(i)(I).") This subsection of the Code sets the additional interest as the "underpayment rate plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year." I.R.C. § 409A(a)(1)(B)(i)(I) (2006)).

*B. Notice 2008-115**1. Reporting Obligations*

For the 2008 taxable year, the Service again postponed the obligation of employers to report nonqualified deferred compensation that is deferred by an employee.¹³⁰ This postponement is effective until the Treasury Department and the Service issue additional guidance.¹³¹ Section 885(b) of the American Jobs Creation Act of 2004 amended I.R.C. § 6051.¹³² This amendment, coupled with I.R.S. Notice 2005-1 provides that amounts deferred as nonqualified deferred compensation must be reported on an employee's Form W-2 in Box 12 using code Y.¹³³ If the person deferring the compensation receives a Form 1099-MISC instead of a Form W-2, the nonqualified deferred compensation is to be reported in Box 15a.¹³⁴ In Notice 2008-115, the Service permanently waived these reporting requirements for the 2008 taxable year and all future years until the Treasury Department and the Service issue additional guidance.¹³⁵

If the employee received a distribution from a nonqualified deferred compensation plan, the employer must report the amount of the payment on the employee's Form W-2 in box 12 using code Z and include the amount in box 1.¹³⁶ If the person receives a Form 1099 instead of a Form W-2, the employer must report the nonqualified deferred compensation received in box 15b and also in box 7.¹³⁷

2. Calculating Amounts Includible Under § 409A

Notice 2008-115 also provides interim guidance for taxpayers on determining the amount of income to be included in an employee's gross income when a nonqualified deferred compensation plan no longer meets § 409A's requirements and thus the nonqualified deferred compensation

¹³⁰ I.R.S. Notice 2008-115, 2008-52 I.R.B. 1367.

¹³¹ *Id.*

¹³² See American Jobs Creation Act of 2004 § 885(b), I.R.C. § 6051 (2006).

¹³³ *Id.*; I.R.S. Notice 2005-1, 2005-2 I.R.B. 274.

¹³⁴ See American Jobs Creation Act of 2004 § 885(b), I.R.C. § 6051; I.R.S. Notice 2005-1, 2005-2 I.R.B. 274.

¹³⁵ I.R.S. Notice 2008-115, 2008-52 I.R.B. 1367.

¹³⁶ *Id.*

¹³⁷ *Id.*

must be included in the employee's gross income.¹³⁸ Guidance is given for account balance plans and non-account balance plans.¹³⁹ Guidance is also given for stock rights.¹⁴⁰ For other deferred amounts, the amount includible "must be determined under a reasonable, good faith application of a reasonable, good faith method."¹⁴¹ As noted below,¹⁴² the Treasury Department and the Service have also issued a proposed regulation addressing the amount to be included in an employee's gross income when a nonqualified deferred compensation plan fails to comply with I.R.C. § 409A.¹⁴³ Notice 2008-115 provides that taxpayers may rely upon either Notice 2008-115 or the proposed regulation provided that if the taxpayer relies upon the proposed regulation then the taxpayer must comply with every provision of the proposed regulation.¹⁴⁴

C. Prop. Treas. Reg. § 1.409A-4

On December 8, 2008, the Treasury Department and the Service issued Proposed Treasury Regulation § 1.409A-4 addressing the calculation of the amount of nonqualified deferred compensation that must be included in an employee's gross income as a result of a plan failing to comply with I.R.C. § 409A.¹⁴⁵ The proposed regulation provides detailed guidance and many examples on determining the amount to be included and the proper year to include such amount.¹⁴⁶

Proposed Treasury Regulation § 1.409A-4(a)(1)(ii) provides that each taxable year is analyzed independently of other taxable years when determining the amount includible.¹⁴⁷ The proposed regulation provides "an amount may be includible in income for a taxable year during which a plan fails to meet the requirements of section 409A(a), even if the same amount was includible in income in a previous taxable year, except to the

¹³⁸ *See id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *See infra* Part III.C.

¹⁴³ *See* I.R.S. Notice 2008-115, 2008-52 I.R.B. 1367. (citing Prop. Treas. Reg. § 1.409A-4, 73 Fed. Reg. 74,380 (Dec. 8, 2008)).

¹⁴⁴ I.R.S. Notice 2008-115, 2008-52 I.R.B. 1367.

¹⁴⁵ Prop. Treas. Reg. § 1.409A-4, 73 Fed. Reg. 74,380, 74,393–403 (Dec. 8, 2008).

¹⁴⁶ *See id.*

¹⁴⁷ *Id.* at 74,393.

extent” that the income was previously included in gross income.¹⁴⁸ This is illustrated by an example: “Employee A has a total amount deferred under a nonqualified deferred compensation plan of \$0 in 2010, \$100,000 in 2011, and \$250,000 in 2012. No payments are made under the plan.”¹⁴⁹ The example posits that the plan fails to meet § 409A’s requirements in 2011 and 2012.¹⁵⁰ The example concludes that Employee A includes \$100,000 in 2011 and \$150,000 in 2012.¹⁵¹ Further, Employee A cannot avoid including \$100,000 in 2011 by including \$250,000 in 2012.¹⁵² The example assumes that none of the nonqualified deferred compensation is subject to a substantial risk of forfeiture.¹⁵³ In the second example, the proposed regulation provides that if “the statute of limitations on assessments has expired for 2011,” then Employee A includes \$250,000 in 2012 because the \$100,000 for 2011 was never included in Employee A’s income.¹⁵⁴

Prop. Treas. Reg. § 1.409A-4 also provides that if a nonqualified deferred compensation plan provides for payment at alternative times or in alternative forms, then the time and form that generates the highest value must be used.¹⁵⁵ The proposed regulation contains many examples.¹⁵⁶ One example assumes that an employee is entitled to a single sum payment “upon the earlier of January 1, 2020 or [the employee’s] separation from service.”¹⁵⁷ In 2010, the nonqualified deferred compensation plan no longer complies with I.R.C. § 409A and on the last day of the 2010 taxable year, the employee has not separated from service.¹⁵⁸ Thus, “[t]he total amount deferred for 2010 is the greater of the amount that would be

¹⁴⁸ *Id.*

¹⁴⁹ Prop. Treas. Reg. § 1.409A-4(a)(1)(iii), 73 Fed. Reg. 74,380, 74,394 (Dec. 8, 2008).

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *See id.*

¹⁵⁴ *Id.*

¹⁵⁵ Prop. Treas. Reg. § 1.409A-4(b)(2)(vi), 73 Fed. Reg. 74,380, 74,396 (Dec. 8, 2008).

¹⁵⁶ *See* Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), 73 Fed. Reg. 74,380, 74,397–98 (Dec. 8, 2008).

¹⁵⁷ *Id.* at 74,398 (ex. 8).

¹⁵⁸ *Id.*

payable on December 31, 2010 or the present value of the amount that would be payable on January 1, 2020.”¹⁵⁹

IV. I.R.C. § 409A AND THE CLOSELY-HELD BUSINESS

For many closely-held businesses, nonqualified deferred compensation provides no tax benefit and requires that the parties deal with the complexity of I.R.C. § 409A.¹⁶⁰ Often a closely-held business is owned entirely or in large part by a single shareholder.¹⁶¹ This raises two issues limiting the effectiveness or desirability of nonqualified deferred compensation.

A. “Traditional” Nonqualified Deferred Compensation

The first issue is whether the Service will even respect the nonqualified deferred compensation agreement when it involves a corporation and its controlling shareholder-employee who is eligible to participate in the nonqualified deferred compensation plan. For many years, the Service has refused to issue private letter rulings on this point.¹⁶² Presumably, the problem is that the nonqualified deferred compensation agreement would not be an arm’s length, bargained for agreement. Under the constructive receipt doctrine, there would be no significant limitation or restriction on the owner-employee’s ability to receive the cash.

Even disregarding the first issue, the second issue is the tax effectiveness of nonqualified deferred compensation. Often closely-held businesses are structured as pass-through taxation entities.¹⁶³ The closely-held businesses are either taxed as Subchapter S corporations or limited

¹⁵⁹ *Id.*

¹⁶⁰ See generally William A. Drennan, *Einstein’s Theory of Taxation Explains the Nonqualified Deferred Compensation Rules!*, 40 U. TOL. L. REV. 53, 54–55 (explaining that § 409A will impose heavy burdens on small businesses, including spending “significant time and effort” to interpret the complex rules); see also *supra* notes 8–9 and accompanying text.

¹⁶¹ See Lyle L. Simpson, D. Scott Simpson & Rod Kubat, *Special Shareholder Concerns in the Closely Held Corporation*, in IOWA STATE BAR ASSOCIATION BUSINESS LAW MANUAL 278, 279 (2005).

¹⁶² Rev. Proc. 2009-3, 2009-1 I.R.B. 107.

¹⁶³ See *supra* note 8 and accompanying text.

liability companies taxed as partnerships or disregarded entities.¹⁶⁴ The tax benefits of nonqualified deferred compensation are realized when the employer and the employee receiving the nonqualified deferred compensation are separate economic actors. The employer must forgo its current income tax deduction until the compensation is actually paid to the employee.¹⁶⁵ The employee does not include the deferred compensation until actually or constructively received.¹⁶⁶ If the taxable income of the business flows through to the owner-employee's personal income tax return because the business is an S corporation or taxed as a partnership, then the benefits of deferral are lost.¹⁶⁷ Even so, a closely-held business still may consider using nonqualified deferred compensation for some of the reasons outlined below.

1. Cash Flow Considerations

A small business owner-employee may be concerned about cash flow. Nonqualified deferred compensation is a way to ensure that the owner-employee receives compensation for his or her services even if the business does not have the current cash flow to pay the employee. This is most applicable when there are other owners of the business who are not also employees. Merely dividing the profits of the business might not adequately compensate the owner-employee.

To help manage cash flow in later years, an owner-employee of a closely-held business might also consider using a nonqualified deferred compensation plan. If, before the end of the preceding taxable year, an owner-employee anticipated a financially difficult year for the business, the owner-employee might wish to defer some compensation so as to ease the cash flow needs of the business in the upcoming taxable year while still preserving the right to such compensation. This strategy can be risky,

¹⁶⁴ "An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member." Treas. Reg. § 301-7701-3(f)(2) (as amended in 1995).

¹⁶⁵ I.R.C. § 404(a)(5) (2006).

¹⁶⁶ *Id.* § 451(a); *see also* Treas. Reg. § 1.451-1(a) (as amended in 1978).

¹⁶⁷ *See* GOLDSTEIN ET AL., *supra* note 9, at 213–14 ("[O]ne of the primary purposes of [nonqualified deferred compensation]—tax deferral for the employee—is not realized for an S corporation shareholder. . . . [A nonqualified deferred compensation] plan for all the partners of a partnership will not provide the partners with a tax deferral.").

however, because if the company declares bankruptcy, the owner-employee will have only the rights of an unsecured general creditor.¹⁶⁸

2. *Funding Retirement*

Even without the tax benefits, an owner-employee of a closely-held business still may consider nonqualified deferred compensation in the context of succession planning. Often the owner-employee has spent his or her adult life building, nurturing, and growing the closely-held business into the profitable venture that it is. When the owner-employee decides that it is time to retire, or at least that it is time to begin transferring control of the business to others, the question becomes what is the most tax efficient way to do so while providing for the needs of the founder. Often, most of the owner-employee's wealth is in the business itself.¹⁶⁹

Several options present themselves. First, the owner-employee could sell the business to a third party. Assuming no seller-financing, the owner-employee will pay capital gains tax upon the sale proceeds reduced by the minimal basis the client has in his or her stock.¹⁷⁰ The owner-employee will take the proceeds and place them in other investments to generate needed income. The outright sale is a simple solution but one that might not meet the overall estate planning goals of the owner-employee.

Often the owner-employee will desire to transfer the closely-held business to a succeeding generation or key employees. Such a transfer could be accomplished in two ways. First, the owner-employee could sell his or her shares to the next generation or the key employee. This achieves the result of liquidating the owner-employee's interest in the closely-held business but it raises several additional issues. As above with the sale to a third party, the owner-employee would recognize income on the sale and

¹⁶⁸ See Rev. Proc. 92-65, 1992-33 I.R.B. 16 ("The plan must provide that participants have the status of general unsecured creditors of the employer and that the plan constitutes a mere promise by the employer to make benefit payments in the future.").

¹⁶⁹ LOREN W. TAUER & DALE A. GROSSMAN, ESTATE AND SUCCESSION PLANNING FOR SMALL BUSINESS OWNERS 2 (2002), available at http://aem.cornell.edu/outreach/extensionpdf/2002/Cornell_AEM_eb0205.pdf.

¹⁷⁰ Cf. I.R.C. § 1001(a) (calculating the gain from sale or other disposition of property to be the amount realized over the adjusted basis); *id.* § 1221(a) (defining "capital asset" as "property held by the taxpayer"). In a seller-financing scenario, the owner-employee will recognize gain on a portion of each installment payment. See *id.* § 453.

pay capital gains tax.¹⁷¹ It is less likely that the succeeding generation or a key employee would have the financial means to accomplish the sale. It is possible that the succeeding generation or key employee could obtain bank financing but the terms may not be sufficiently favorable and the succeeding generation or key employee may not want to accept the bank oversight that might come with a large loan. Finally, much estate planning leverage is lost by such a plan. If the owner-employee is seeking to reduce gift and estate taxes, a sale that leaves the owner-employee liquid is inefficient planning.¹⁷²

The obstacle for the owner-employee, though, is how to generate sufficient liquidity to fund retirement. Nonqualified deferred compensation is one vehicle available for generating liquidity to meet the owner-employee's retirement needs. The nonqualified deferred compensation payments would be an obligation of the business due to the owner-employee. The payments could be structured to provide liquidity to meet the expected needs of the owner-employee in retirement. The employer may be able to deduct these payments as reasonable compensation if the owner-employee was underpaid in prior years.¹⁷³

¹⁷¹ See *id.* §§ 1001(a), 1221(a).

¹⁷² Ownership interests in a closely-held business are likely subject to a valuation discount for lack of marketability. SHANNON P. PRATT & ALINA V. NICULITA, *VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES* 416 (5th ed. 2008). If gifts are being considered, then minority interest discounts should also be appropriate. See Stephen A. Hess, Annotation, *Use of Marketability Discount in Valuing Closely Held Corporation or Its Stock*, 16 A.L.R. 6TH 693, 748 (2006) (citing numerous cases supporting this proposition). If the owner-employee liquidates his or her investment, then any valuation discounts are likely lost. Likewise, if the owner-employee desires to transfer ownership of the business to a succeeding generation, gifting ownership interests to irrevocable trusts for the benefit of the owner-employee's descendants is a beginning step in the business succession planning process. See DAVE JONES, *FAMILY BUSINESS SUCCESSION PLANNING* 3 (2008), http://www.selectportfolio.com/resource_library.aspx (follow "Family Business Succession Planning" hyperlink). The interests gifted to the irrevocable trust should be discounted for their lack of marketability and control in a manner that a gift of cash or marketable securities would not be discounted. See PRATT & NICULITA, *supra*, at 416.

¹⁷³ See *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1245–46 (9th Cir. 1983) (considering factors such as the employee-owner's role in the company and salaries at similar companies when determining the reasonableness of compensation).

3. Key Employees

“Traditional” nonqualified deferred compensation is a useful tool for compensating and retaining key employees. Assuming that the key employee is not a shareholder, the issues that are present with an owner-employee are no longer present. Nonqualified deferred compensation can be used to provide a stream of income for the key employee after his or her retirement. The key employee’s retirement could be based upon attaining a certain age or upon separation from service.

B. Covenants Not to Compete

I.R.C. § 409A is applicable if the deferred payments are related to the performance of services or the non-performance of services with payment in another taxable year.¹⁷⁴ Since non-compete agreements involve the non-performance of services, they present another area of concern when considering succession planning in the closely-held business context. The non-compete agreement might be entered into with a retiring owner-employee or may be entered into with a key employee.

This article first examines how a non-compete agreement might be used with a retiring owner-employee of the closely-held business and the associated § 409A issues. Often the owner-employee is the visionary person with intimate knowledge of this particular business and its market. A concern of any prospective buyer is direct competition with the seller. A prospective buyer desiring to enter a market can either acquire an existing business or can start his or her own new business. Assuming a suitable business exists and the buyer has sufficient capital to make an acquisition, buying an existing business has a number of advantages. With an existing business the buyer will acquire a number of intangibles, including good will, a workforce already in place, and customer contacts. The prospective buyer will also expect that one competitor (the seller) will not be in competition. A non-compete agreement is a good vehicle to accomplish this objective. As a part of the sale negotiations, the prospective buyer might negotiate a non-compete agreement with the selling owner-employee. For a set period of time and within a reasonable geographic area, the seller agrees not to compete with the closely-held business in exchange for some payment.

¹⁷⁴ See T.D. 9321, 2007-19 I.R.B. 1123.

The structuring of the payment will determine if there are any § 409A issues. If the payment is structured as a lump sum payment in the year the non-compete agreement is signed, then there are likely no § 409A issues.¹⁷⁵ The execution of the non-compete agreement and the lump sum payment under the agreement will occur in the same taxable year. A non-compete agreement, however, might need to be negotiated in a prior taxable year with payment delayed until closing in the subsequent taxable year. If so, § 409A issues might arise.¹⁷⁶

A non-compete agreement also might be used to retain a key employee. A key employee has valuable knowledge of the business and its clients. Entering into a non-compete agreement with the key employee limits the key employee's options for leaving to work for a competitor or start a competing business. Again, because the non-compete agreement relates to the non-performance of services, it will be within § 409A's broad reach.

C. Stock Options and Stock Appreciation Rights

Stock options and stock appreciation rights are both good vehicles for incentivizing employees to work hard to increase the value of the business. Depending on the terms of the stock option, it may have § 409A implications.¹⁷⁷ The grant of a stock appreciation right does not have any § 409A implications.¹⁷⁸

1. Stock Options

Stocks options permit the employee to purchase the employer's stock at some future time based upon a price established at the date of the grant of the stock option. Stock options are broadly divided into two categories. The first category is statutory stock options or incentive stock options as described in I.R.C. § 422.¹⁷⁹ For § 409A purposes, this first category also includes stock options under an employee stock purchase plan governed by I.R.C. § 423.¹⁸⁰ These stock options are not subject to § 409A.¹⁸¹

¹⁷⁵ See Treas. Reg. § 1.409A-1(b)(4)(i) (2007).

¹⁷⁶ See T.D. 9321, 2007-19 I.R.B. 1123.

¹⁷⁷ See Treas. Reg. § 1.409A-1(b)(5).

¹⁷⁸ *Id.* § 1.409A-1(b)(5)(i)(B).

¹⁷⁹ I.R.C. § 422 (2006).

¹⁸⁰ See Treas. Reg. § 1.409A-1(b)(5)(ii).

The second category is nonstatutory stock options. This category covers all other stock options. Whether nonstatutory stock options are within § 409A's scope depends upon several facts. Generally, if the exercise price is equal to or greater than the fair market value of the stock on the date of the grant and the number of shares subject to the option is fixed, then the stock option is not subject to § 409A.¹⁸² For example, on June 1, Acme, Inc. stock is valued at \$50 per share. On that date, Acme grants its CEO, Abe, an option to purchase 100 Acme shares at \$50 per share. Abe may exercise the option any time during the next 60 months. The stock options granted are nonstatutory stock options. These stock options are not within § 409A because the exercise price is not less than the fair market value of the stock on the date of the grant of the option and the number of shares subject to the option is fixed at 100.

In a closely-held business,¹⁸³ a valuation issue arises regarding determining the value of the corporation's stock. To avoid the restrictions of § 409A, the exercise price must be equal to or greater than the fair market value of the stock on the date of the grant of the option.¹⁸⁴ In a closely-held business, there is no readily accessible market to provide a value. The regulations provide that when stock "is not readily tradable on an established securities market," any "reasonable valuation method" may be used to determine the value of the stock on the date of the grant of the stock option.¹⁸⁵

2. Stock Appreciation Rights

Stock appreciation rights differ from stock options in that with stock appreciation rights, the employee is entitled only to an amount equal to the appreciation of stock.¹⁸⁶ A stock appreciation right does not give the

¹⁸¹ *Id.*

¹⁸² *Id.* § 1.409A-1(b)(5)(i)(A)(I).

¹⁸³ To qualify under Subchapter S of the Internal Revenue Code, a corporation is permitted to have only one class of stock. I.R.C. § 1361(b)(1)(D). Depending upon its terms, a stock option to purchase S corporation stock may constitute a second class of stock. Further complicating the situation, a stock option might not be considered a second class of stock when issued but upon some future event may become a second class of stock. Obviously, this would prevent a corporation from retaining its S corporation status.

¹⁸⁴ Treas. Reg. § 1.409A-1(b)(5)(i)(A)(I).

¹⁸⁵ *Id.* § 1.409A-1(b)(5)(iv)(B)(I).

¹⁸⁶ See Rev. Rul. 80-300, 1980-2 C.B. 165.

employee the right to buy the underlying stock.¹⁸⁷ An employee is still rewarded for any increase in the value of the corporation but does not receive the right to buy an equity interest. To be outside of § 409A, the employee may not receive any compensation except the excess of the fair market value of the stock on the date of exercise less the fair market value on the date of the grant of the stock appreciation right.¹⁸⁸ As with nonstatutory stock options, the number of shares must be fixed at the date of the grant.¹⁸⁹

D. Profits Interests

A profits interest is a common method of compensating employees of a partnership or a limited liability company taxed as a partnership.¹⁹⁰ A profits interest entitles the employee to share in the profits of the partnership or the limited liability company without giving the employee an equity interest in the business entity.¹⁹¹

Revenue Procedure 93-27 provides guidance on the taxation of profits interests.¹⁹² If certain conditions are met, a profits interest should not be taxable to the employee when received.¹⁹³ Rev. Proc. 93-27 provides: “[i]f a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner,” then the receipt of the profits interest is not a taxable event so long as the profits interest does not “relate[] to a substantially certain and predictable stream of income,” the recipient does not dispose of the interest within two years, and “the profits interest is [not] a limited partnership interest in a ‘publicly traded partnership.’”¹⁹⁴ Any profits received by the employee are included in the employee’s gross income when received.¹⁹⁵

¹⁸⁷ See, e.g., I.R.S. Priv. Ltr. Rul. 93-41-019 (July 16, 1993).

¹⁸⁸ Treas. Reg. § 1.409A-1(b)(5)(i)(A)(I).

¹⁸⁹ *Id.*

¹⁹⁰ Michael D. Thomson, Note, *Receipt of a Partnership Profits Interest for Services: St. John v. United States and a Suggested Solution*, 5 VA. TAX REV. 127, 127 (1985).

¹⁹¹ Rev. Proc. 93-27, 1993-2 C.B. 343.

¹⁹² See *id.*

¹⁹³ See *id.*

¹⁹⁴ *Id.*

¹⁹⁵ See *id.*

A profits interest can motivate an employee to work harder for the partnership or the limited liability company because the employee will share in the profits, if any. The profits interest differs from an annual bonus because the employee can continue to own the profits interest from year to year and even after employment ceases.¹⁹⁶ Control of the business entity is retained by the current owners but the profits are shared with the employee.

The Preamble to the final § 409A regulations notes that neither I.R.C. § 409A or the final regulations directly address the applicability of § 409A to partnerships.¹⁹⁷ Pending further guidance, taxpayers may treat the issue of a profits interest the same as they would treat the “issuance of stock.”¹⁹⁸ A profits interest, though, differs from stock in that with a profits interest, no equity interest is transferred to the recipient.¹⁹⁹

Using a profits interest in a closely-held business to facilitate small business succession planning does bring forth some Chapter 14²⁰⁰ valuation issues that may make the use of a profits interest ultimately undesirable. Chapter 14 is applicable to transfers of an interest in a corporation or a partnership from a transferor to a member of his or her family when the transferor has retained some interest in the transferred property.²⁰¹ When an owner makes a transfer of a profits interest to a member of the owner’s family,²⁰² then the owner has made a transfer in which he or she has retained an interest, namely the underlying capital interest.²⁰³ As a result, § 2701 comes into play with the potential result that the transferor will be considered to have transferred his or her entire interest.²⁰⁴

¹⁹⁶ In fact, a person can own a profits interest despite never having been an employee.

¹⁹⁷ Application of Section 409A to Nonqualified Deferred Compensation Plans, 72 Fed. Reg. 19,234, 19,243 (Apr. 17, 2007).

¹⁹⁸ *Id.*

¹⁹⁹ Rev. Proc. 93-27, 1993-2 C.B. 343.

²⁰⁰ I.R.C. §§ 2701–2704 (2006).

²⁰¹ *Id.* § 2701(a)(1).

²⁰² “The term ‘member of the family’ means, with respect to any transferor—the transferor’s spouse, a lineal descendant of the transferor or the transferor’s spouse, and the spouse of any such descendant.” *Id.* § 2701(e)(1).

²⁰³ See § 2701(a)(3); Treas. Reg. § 25.2701-3 (1992).

²⁰⁴ Treas. Reg. § 25.2701-3.

E. Reimbursement of Dues or Fees

An employer may provide a reimbursement to an employee of certain fees incurred by the employee that are viewed by the employer as helpful to the business of the employer but are not otherwise deductible by the business. For example, the employer might decide that it is helpful for its employee to belong to the local country club. The employer will reimburse the employee for the annual dues of belonging to the country club. This reimbursement to the employee might be includible in the employee's gross income depending upon the decision of the employer to treat the reimbursement as an expense disallowed by I.R.C. § 274(a)(3) or to treat the reimbursement as compensation to the employee.²⁰⁵ If the employer elects to treat the reimbursement as a disallowed deduction under I.R.C. § 274(a)(3), then the employee may exclude the reimbursement as a working condition fringe benefit to the extent that the employee used the country club for business purposes.²⁰⁶ The dues attributable to the employee's personal use of the country club are includible in the employee's gross income.²⁰⁷ If the employer is willing to forgo its income tax deduction and the employee has no personal use of the country club, then there will be no income tax consequences to the employee.²⁰⁸

If the employer decides to treat the reimbursement as compensation to the employee, then the employee must include the reimbursement in his or her gross income.²⁰⁹ No part of the dues may be excluded as a working condition fringe benefit.²¹⁰ Even if the employee uses the country club only for business purposes, the employee is not entitled to a deduction for his or her payment of the country club dues.²¹¹

Suppose an employee has negotiated as part of his or her compensation package that the employer will reimburse the employee for the employee's country club dues each year the employee is employed by the employer.²¹² The employment agreement also provides that if the employee separates

²⁰⁵ See I.R.C. § 274(a)(3).

²⁰⁶ Treas. Reg. § 1.132-5(s) (as amended in 2001).

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ See I.R.C. § 274(a)(3) (2006).

²¹² This example is taken from the regulations. See § 1.409A-3(i)(1)(vi)(ex. 8).

from service, then the employer will reimburse the employee for his or her country club dues for the year of separation and the next three years up to \$90,000. The employer is obligated by the agreement to make the reimbursement payment by the end of the calendar year following the year in which the employee paid the country club dues.

At first glance, this may appear to be nothing more than a reimbursement rather than nonqualified deferred compensation. Nevertheless, this reimbursement plan for country club dues does raise I.R.C. § 409A issues. In order for the reimbursement payments to be considered on a fixed schedule to meet the payment requirements of § 409A, a payment in one year cannot affect the amount of a payment in another year.²¹³ Here, the employment agreement provides that the employee will be reimbursed up to \$90,000 for country club dues paid in the year of separation and the three subsequent years. The amount of the country club dues could vary. As a result, more dues might be reimbursed in the earlier years leaving less of the \$90,000 to reimburse the employee in the later years. Thus, the arrangement will violate I.R.C. § 409A.²¹⁴

V. EXAMPLE

The section contains a hypothetical example to show how nonqualified deferred compensation might be used in small business succession planning. The hypothetical example also explores the I.R.C. § 409A implications of common business succession planning techniques.

A. *The Facts*

The facts of this hypothetical example are loosely based on the sample problem used by many presenters at the symposium.²¹⁵ In many respects, the original fact pattern was broad and flexible. This encouraged discussion of available planning opportunities to meet the goals of the various family members and sometimes conflicting goals of the various family members. I have both augmented and trimmed the fact pattern to

²¹³ *See id.*

²¹⁴ *Id.*

²¹⁵ Symposium, *Small Business Succession Planning: Helping the Family, Building the Plan*, Jointly Presented by the Society of Financial Service Professionals & Capital University Law School Business and Tax Institute (Oct. 22, 2008).

highlight the I.R.C. § 409A issues that might arise in small business succession planning.

1. Frank

Frank founded Widgets, Inc. when he was 30 years old. Frank is married to Faye. They have 2 children, Stan and Debi. Each is married.

Frank is now 60 years old and starting to think about retirement. He currently takes \$150,000 in salary and has been able to comfortably meet all of his expenses. Frank anticipates that he will need to earn about \$100,000 per year in retirement to meet his expenses. Frank is concerned about his cash flow, particularly during the early years of his retirement when Frank and Faye expect to travel more. Frank is uncertain about how long he would like to work but thinks it will be until age 65 or later.

2. Ken

Ken is the general manager of Widgets, Inc. Ken is a long-time employee and has been with Frank since the beginning. Ken is concerned about his continued employment and his eventual retirement. Ken is 55 years old. Frank has paid Ken a competitive salary and provided good benefits but Ken has never had an ownership interest in Widgets, Inc. Ken has valuable know-how and client contacts. Ken is concerned with having a job for another 10 years or more. If Frank retires and begins transferring ownership to the succeeding generation, Ken's expertise in managing Widgets will be essential to the succeeding generation. Likewise, Ken wants to know that he will be "taken care of." Ken is not a family member and it is unlikely at this late stage that Frank will transfer an equity interest to Ken.

3. Stan

Stan is Frank and Faye's son. He currently works at Widgets, Inc. Stan envisions himself stepping into Frank's position upon Frank's retirement. Stan expects that he will eventually own Widgets, Inc. when Frank and Faye have both died. Stan is married to Sally.

4. Debi and Doug

Debi is Frank and Faye's daughter. She is married to Doug. Doug also works in the business. He has been the head of the new Gadget division since its inception two years ago.

Frank would like to incentivize Doug to keep working hard and spending the long hours required to develop the new division. At the same time, Frank is reluctant to transfer an equity interest to Doug because

Frank prefers that ownership stay within the group of Frank's descendants. Doug has hinted that he may want to go out on his own.

B. "Traditional" Nonqualified Deferred Compensation

"Traditional" nonqualified deferred compensation as used in this article refers to a nonqualified agreement or plan in which the employee defers compensation to some future taxable year or years.

1. Frank

Using traditional nonqualified deferred compensation for Frank has some risks. First, assuming that Frank is the controlling shareholder of Widgets, Inc., the Service might not respect the agreement. The Service has identified this as an area where it will not issue private letter rulings.²¹⁶ Second, if Frank is the controlling shareholder, or possibly the only shareholder, then there are no tax advantages to be gained by deferring the compensation to a future taxable year.²¹⁷

Still, Frank is concerned about liquidity in his retirement. Nonqualified deferred compensation is one way to create liquidity for Frank in his retirement. Frank could agree to defer some of his current compensation each year until either a specified age or until Frank's separation from service. If separation from service is going to be the trigger, then Frank's current duties should be memorialized so that upon his separation from service it will be clear that Frank's level of service has fallen below 20% of his previous level thus meeting the safe harbor of the final regulations.²¹⁸

2. Ken, Stan, and Doug

"Traditional" nonqualified deferred compensation would work very well with Ken, Stan, and Doug. If we begin with the assumption that none

²¹⁶ Rev. Proc. 2008-61, 2008-42 I.R.B. 934.

²¹⁷ See *supra* Part IV. Depending upon the overall estate plan developed for Frank and Faye, at some point in time it may be that Frank will no longer be a controlling shareholder of Widgets, Inc. Such a moment would be a better time to enter into the nonqualified deferred compensation agreement. See *supra* Part IV.A.2. If Frank is no longer the controlling shareholder, then the issue of whether the Service will respect the nonqualified deferred compensation plan should be moot. See *supra* Part IV.A.3.

²¹⁸ See Treas. Reg. § 1.409A-1(h)(1)(ii) (2007).

of these three employees has an ownership interest in Widgets, then there are benefits of tax deferral to be obtained by each employee.

A difficult issue to address is whether a trigger based upon a change of control should be included in the nonqualified deferred compensation plan for Ken. There are competing concerns here. Ken has worked with Frank for 30 years. Presumably, Ken is comfortable with his relationship with Frank and the security that having Frank in charge provides. A large unknown is Frank's estate planning for transferring the ownership of the business. Frank could embark upon a plan of substantial gifting and selling of his interests in Widgets to family members, trusts for the benefit of family members, and possibly a family limited partnership.

C. Covenants Not to Compete

1. Frank

Suppose that Frank decided to sell Widgets, Inc. to Bill, a competitor. Frank and Bill agree on November 1, year 1, on the terms of a non-compete agreement in which Frank agrees that he will not compete with Widgets for a certain time and in a certain geographical area. A single sum payment is to be made to Frank at closing. Closing is scheduled for February 1, year 2.

Frank's promise not to compete with Widgets, Inc. is given in year 1, which is not the same taxable year as Widget's single sum payment to Frank. This creates a § 409A issue because the non-compete agreement defers compensation to a subsequent taxable year.²¹⁹ In this example, the short-term deferral rule of § 409A likely prevents a violation of § 409A. The short-term deferral rule provides that payments made with 2½ months of the end of the taxable year do not constitute deferred compensation for § 409A purposes.²²⁰

2. Ken, Stan, and Doug

A non-compete agreement would work well with Ken, Stan, and Doug. Each is a valuable employee to Widgets, Inc. A non-compete agreement with Ken would provide Stan and Doug some assurance that Ken and his know-how will remain at Widgets, or at least not be lured away to be in competition with Widgets.

²¹⁹ See *supra* Part IV.B.

²²⁰ Treas. Reg. § 1.409A-1(b)(4)(i) (2007).

A non-compete agreement with Doug has a similar benefit of tying Doug to Widgets. As head of the new Gadget division, Doug has substantial expertise in a growing area of the business. If Doug does not receive an equity interest in Widgets, Doug may consider going elsewhere. A non-compete agreement is one way to keep Doug with Widgets, Inc. and the Gadget division.

Any non-compete agreement with any of Ken, Stan, and Doug needs to be structured to comply with § 409A or an exception to it.

D. Stock Options and Stock Appreciation Rights

1. Stan

It is possible that Stan could be retained with stock options. If the strike price of the options on the date of the grant is equal to or greater than the value of the stock on the date of the grant, then the options will not be subject to the strict requirements of I.R.C. § 409A.²²¹ If the strike price is less than the fair market value of the stock on the date of the grant, then I.R.C. § 409A will apply.²²²

In a closely-held corporation, the valuation of the stock on the date of the grant of the stock option will present valuation challenges. It will be crucial to document the value of the stock so as to avoid controversy later with the Service.

2. Ken and Doug

Stock options are not likely the right planning device to compensate Ken and Doug given Frank's preference for keeping ownership of Widgets, Inc. in the family. Stock appreciation rights, though, may be a useful business succession planning technique. Granting Ken and Doug stock appreciation rights allows each of them to share in the growth of Widgets, Inc. The stock appreciation right must provide that each is entitled only to the excess of the fair market value of the stock on the date of exercise less that fair market value on the date of the grant.²²³ Further, the number of shares subject to the grant must be fixed.²²⁴

²²¹ *Id.* § 1.409A-1(b)(5)(i)(A)(I).

²²² *See id.*

²²³ *See id.*

²²⁴ *See id.*

E. Profits Interests

If Widgets is a partnership or a limited liability company taxed as a partnership, then Frank might consider granting a profits interest to one or more of Widgets employees.

Frank may consider giving Stan a profits interest. A profits interest incentivizes Stan to work hard and continue to build the business. Stan's personal financial gain is directly related to the success of the business. Since it is anticipated that Stan will have an ownership interest, Stan should be able to meet the requirements of Rev. Proc. 93-27.²²⁵ Giving Stan an equity interest does raise Chapter 14 issues.²²⁶ Given the gift tax cost associated with giving Stan a profits interest, this is not likely the best option to motivate Stan. Similarly, the entity may consider giving Doug a profits interest but it will raise the same Chapter 14 issues.

Frank may consider giving Ken a profits interest. Since Ken is not a family member, there will be no Chapter 14 issues with the transfer of a profits interest to Ken.²²⁷

F. Continuation of Club Dues

If Widgets, Inc. has been paying for Frank's country club dues, it could continue to reimburse Frank for that expense. If one of Frank's concerns is liquidity after retirement, knowing that the country club dues will be paid for some specific period helps Frank because it is no longer an out of pocket expense for him. Since Frank is likely to no longer be an employee of Widgets, the entire amount of the reimbursement will likely be included in Frank's gross income.²²⁸ Still, Frank is receiving a benefit for substantially less than it would cost him to acquire it on his own.

The reimbursement should be set as a fixed amount over a specific period. If Widgets agrees to reimburse Frank up to a certain amount over several years, that payment schedule will run afoul of § 409A's requirement of a fixed payment schedule. As a result, Frank will have to include the entire amount of the promised reimbursement in the earliest taxable year.²²⁹

²²⁵ 1993-2 C.B. 343.

²²⁶ See *supra* Part IV.D.

²²⁷ See I.R.C. § 2701(e)(1) (2006) (defining "member of the family").

²²⁸ See Treas. Reg. § 1.409A-1(b)(9)(v).

²²⁹ See *id.*

VI. CONCLUSION

The enactment of I.R.C. § 409A has changed dramatically the landscape of nonqualified deferred compensation for publicly-traded corporations but has also had an impact on closely-held businesses. Practitioners need to be aware that the broad reach of § 409A creates § 409A issues for small businesses where none previously existed. Although it can be a trap for the unwary, with careful planning, nonqualified deferred compensation can be a useful tool for small business planning.