March 30, 2008

Einstein's Theory of Taxation

William A Drennan

Available at: https://works.bepress.com/william_drennan/2/
Albert Einstein said “the hardest thing in the world to understand is the income tax.” The new nonqualified deferred compensation ("NQDC") rules are a testament to Einstein’s brilliance and foresight.

The government followed a twisted path in revolutionizing the taxation of NQDC. Initially, Congress desired to curb excessive CEO compensation at publicly traded corporations. However, the government quickly veered off course, and focused on
NQDC. Along the way, Congress passed Internal Revenue Code Section 409A (“409A”); the Treasury Department enacted a gargantuan preamble and final regulations package consisting of 91 pages in the Federal Register,\(^3\) and the IRS issued eight Notices\(^4\) providing guidance on how to interpret and implement the new rules. The six-year journey has ended, and the government has created a complex and bizarre minefield.

Unfortunately, 409A will not curb excessive CEO compensation at publicly traded corporation, and will impose heavy burdens on charities, small businesses, and their employees. 409A applies to all employers, and almost all employers will incur significant 409A administrative costs. Advisors will need to spend significant time and effort to understand the rules. Employers must now formalize previously unwritten arrangements in writing, and must amend arrangements that previously were documented. Employers and employees will need to adopt new agreements and amendments, and administer them according to the new requirements. The income tax system already imposes staggering administrative burdens on businesses and individuals.

“Ordinary citizens and businesses waste about $125 billion every year – [almost] 13 cents for every [income] tax dollar collected – trying to comply with . . . or avoid [the income tax laws.]”\(^5\) 409A makes a bad situation worse.

\(^3\) 72 Fed. Reg. 19234-19325 (April 17, 2007).
\(^5\) Michael J. Graetz, Taxes That Work: A Simple American Plan, 58 Fla. L. Rev. 1043, 1046 (2006) (citing Joel Slemrod, Presentation to the President’s Advisory Panel on Federal Tax Reform: The Costs of Tax Complexity (Mar. 3, 2005), available at http://www.taxreformpanel.gov/meeting/docs/slemrod_03032005.ppt). Individuals spend $85 billion and businesses spend $40 billion. Id. These figures “include[] the value of 3.5 billion hours of time.” Id. The $125 billion compliance cost is approximately 12.5% of the total income tax receipts of $998.4 billion. Id. These figures apparently do not include employment taxes. With employment taxes, taxpayers paid total taxes of $1.767 trillion in 2001. See infra note 8. “Filing a tax return no longer links the American people to their government. Instead, it is just one more commercial operation. H&R Block, Jackson-Hewitt,
Even more disturbing, complex tax laws like 409A contribute to the erosion of voluntary compliance with our income tax laws. Voluntary compliance is the foundation of the U.S. tax system. All taxpayers with sufficient gross income are required to file a tax return,\textsuperscript{6} and report their income and deductions. Many taxpayers report and pay the correct amount – their fair share.\textsuperscript{7} However, noncompliance is rampant. On average, U.S. taxpayers only pay 85\% of the federal income taxes they should pay.\textsuperscript{8} The IRS audits about 1\% of all income tax returns filed,\textsuperscript{9} so typically the amount reported by the taxpayer on the original tax return filed with the IRS is never challenged.\textsuperscript{10} Even in areas in which noncompliance is high, IRS audit rates are low. For example, even though “self-employed individuals operating businesses on a cash basis report just 19\% of their tax liability,”\textsuperscript{11} and a legion of accountants sit between Americans and their government.” Graetz,\textit{ supra,} at 1046.

\textsuperscript{6} See \textit{e.g.} IRC § 6012(a)(1)(A).

\textsuperscript{7} As a practical matter, many taxpayers have no choice other than to report the correct amount of gross income. Payers must report wages, interest, dividends, proceeds from the sale of securities or real estate, and certain other types of income paid to individuals, directly to the IRS (on Forms W-2 or 1099). \textit{See IRC §§ 6041(a), 6051(a).} If an individual fails to file an income tax return, or fails to report W-2 or 1099 income on his or her income tax return, the IRS will detect the omission through a computer matching program, and will send the taxpayer a notice.

\textsuperscript{8} Understanding the Tax Gap, IRS FS 2005-14, March, 2005, \textit{available at} http://www.irs.gov/newsroom/article/O_.id=137246.00.html (“For Tax Year 2001, all taxpayers paid $1.767 trillion on time, a figure that represents from 83.4 percent to 85 percent of the total amount due.”).

\textsuperscript{9} “Overall, the IRS audits about 1 percent of individual returns.” Associated Press, \textit{Survey: Taxpayers believe in paying fair share,} Grand Rapids Press, Feb. 27, 2008, at A10, \textit{available at} 2008 WLN 2904353; \textit{Loose Change,} Fort Worth Star-Telegram, Feb. 17, 2008, \textit{available at} 2008 WLN 3107060 (“Only about 1 percent of all individual income-tax returns filed in each of the past few years have been audited.”). “The rate of face-to-face audits of individual taxpayers . . . . [is] 1.6 audits for every 1,000 returns.” Jonathan Weisman, \textit{Newly ‘aggressive’ IRS still audits less; Agency’s gains are computer-based, study says,} San Francisco Chronicle, April 12, 2004 (reporting on data compiled by Syracuse University’s Transactional Records Access Clearinghouse). “Only 0.73 percent of business tax returns were audited in the fiscal year that ended Sept. 30 [2003], down from 0.88 percent in the previous year . . . .” \textit{Id.}

\textsuperscript{10} One commentator states, \textit{“It is important that there be broad public support for the system. In the U.S. . . . taxpayers make the first determination of their liabilities through the returns they prepare and file . . . . [W]ith the low IRS audit coverage that currently prevails, that first determination is usually the last . . . . [T]hus it is important that taxpayers have sufficient commitment to the system that their returns bear [a] reasonable relation to reality.”} Steven R. Johnson, \textit{Administrability-Based Tax Simplification,} 4 Nev. L.J. 573, 581 (2004).
income to the IRS,”\textsuperscript{11} the IRS audits only 2.13\% of self-employed individuals.\textsuperscript{12} Voluntary compliance with our tax laws is crucial.

This Article asserts that 409A will fail to achieve its intended purpose of curbing excessive CEO compensation at publicly traded corporations, and will create needless complexity. “Complex laws . . . contribute to taxpayer confusion and real or perceived unfairness in the tax system. Studies have shown that taxpayers are less likely to be compliant if they perceive the tax system to be inequitable.”\textsuperscript{13} The 409A rules demonstrate that lawmakers at various levels often fail to consider the impact of complexity.

Part I of this Article describes the government’s initial steps and missteps that led to 409A. After Part II of this Article reviews 409A, Parts III through VI analyze the fiendish 409A regulations, emphasizing the practical problems for small businesses, charities, and their employees. In conclusion, this Article asserts that lawmakers should consider the negative effects of complexity before passing a law.

I. THE GOVERNMENT ABANDONS A WORTHY MISSION FOR A TRIVIAL TANGENT

\textit{“ENRON – THE MUSCIAL COMEDY!”}\textsuperscript{14}

\textit{“If you become a CEO, success will be richly rewarded. So will failure. You won’t do too bad in a comma either.”}\textsuperscript{15}


\textsuperscript{12} \textit{Id.}.

\textsuperscript{13} Yablon, \textit{supra} note 1, at 114 (quoting George K. Yin).

\textsuperscript{14} \textit{See} Alex Gibney, Enron: The Musical, \textit{available at} http://www.landmarktheatres.com/mn/enron.html.

“Then our CEO backed up a moving van to the building and robbed us. At first we thought he was breaking the law, but he had a written opinion from his tax lawyer saying it was probably okay.”\textsuperscript{16}

The 409A trip began when U.S. Senators called for a study of the outrageous compensation practices at Enron Corporation.\textsuperscript{17} A 732-page report (the “Enron Compensation Report”)\textsuperscript{18} revealed that Enron’s top executives used a stock option program to fleece the company. The year before filing bankruptcy, Enron paid its top 200 executives over $1.4 billion in total compensation, an average of over $7.45 million per executive.\textsuperscript{19} Over two-thirds of that amount was stock option compensation.\textsuperscript{20} As a result, the corporation declared bankruptcy the next year, and “[thousands of] Enron’s rank-and-file employees [lost] virtually all of their retirement savings”\textsuperscript{21} and their jobs.

Rather than enacting a tax statute to restrain the amount of stock option compensation for top executives at publicly-held corporations, Congress passed IRC § 409A (“409A”).\textsuperscript{22} Although the legislative history states that 409A was enacted in response to the abuses at Enron:\textsuperscript{23}

\textsuperscript{16} Yablons, supra note 1, at 158 (quoting Scott Adams (“Dilbert”)).
\textsuperscript{17} At its peak, Enron was seventh in the Fortune 500, and had over 25,000 employees. Joint Committee on Taxation, 108\textsuperscript{th} Cong., Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS-3-03), at page 5 (February 2003), available at \url{http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html} [hereinafter Enron Compensation Report].
\textsuperscript{18} Id.
\textsuperscript{19} In 2000, Enron paid its top 200 executives $1.424 billion in total compensation. Of that amount, $1.063 billion was from stock options. Id. at 547. Enron filed for bankruptcy on December 3, 2001. Id. at 575.
\textsuperscript{20} Id.
\textsuperscript{21} Id. at 37.
• 409A imposes no limit on the amount of compensation that employers can pay or deduct; it merely regulates the timing of certain compensation payments.

• 409A imposes no meaningful restriction on stock options. In fact, 409A provides publicly traded corporations and their top executives with a roadmap for structuring stock options to avoid any timing restrictions that 409A otherwise would impose. 24

• The Enron Compensation Report does not even suggest that Enron’s stock option shenanigans merit further study. Rather, the Report meekly states that Enron’s stock option program appears to satisfy existing law. 25

Instead of taking on the problem of excessive CEO compensation at publicly-traded corporations, the government went off on a trivial tangent. Section 409A merely regulates the timing of nonqualified deferred compensation ("NQDC"). 26 NQDC accounted for less than 5% of the total compensation for Enron’s top executives. 27 The legislative history indicates that Congress intended 409A to regulate traditional NQDC, although 409A will impact some other compensation arrangements. 28 In traditional NQDC arrangements, the employee agrees that part of his or her salary or bonus for the part from the recent corporate scandals and a related public perception of excessive executive pay . . . .

In fact, the Enron Compensation Report is the only item of empirical research cited by the government in the legislative history.

25 Enron Compensation Report, supra note 17, at 41.
26 See infra Part II.A for a more detailed description of traditional NQDC; see infra notes 44-47 and accompanying text.
current year will be paid in a future year, usually when the employee retires. 409A will apply to all employers, including small businesses like Bubba’s Produce in New Orleans, and charities like the Boy Scouts of America Greater New York Councils. A 1996 study reported that over 23,000 employers maintain traditional NQDC plans.

409A will have no meaningful impact on publicly traded corporations and their top executives because (i) 409A places no restriction on the amount of compensation that corporations can pay and deduct, and (ii) their sophisticated advisors will be able to comply with 409A’s timing rules. In contrast, small businesses, charities, and their employees likely will be caught in various traps for the unwary.

---

30 409A makes only two distinctions between publicly traded corporations and all other employers, and those two distinctions are trivial. First, IRC § 409A(a)(2)(B)(i) provides that if a publicly traded corporation will make an NQDC payment to a key employee upon separation from service, the first payment must be delayed at least six months. Second, a publicly traded corporation can delay a NQDC payment to a top executive if the corporation would not be allowed to claim a tax deduction for the payment because of the $1 million restriction of IRC § 162(m). Treas. Reg. § 1.409A-2(b)(7) (2007). Under IRC § 162(m), in any one year, a public corporation cannot claim a tax deduction for fixed compensation in excess of $1 million paid to its CEO, or any of its next four highest-ranking officers. This opportunity to re-defer is actually an extra benefit to top executives at publicly traded corporations because it allows them additional flexibility in timing NQDC payments. Under 409A, normally to further extend the payment of NQDC benefits, the parties must agree to the extension at least one year before the payment is due, and extend the payment for at least five years. IRC § 409A(a)(4)(C); see supra notes 140-43.

32 IRS Notice 2007-100, 2007-52 I.R.B. 1243 (Dec. 3, 2007) provides very limited relief for certain inadvertent errors. The relief is only available for errors in “operating” a NQDC plan, and is unavailable for errors in drafting or amending NQDC plan documents. Also, the IRS only makes the relief available for inadvertent operational errors occurring before January 1, 2010. The IRS reports that it is considering a program to provide additional relief. Id.
II. THE STATUTORY TREES BEFORE THE REGULATORY FOREST – IRC § 409A

“[America’s tax laws] are constantly changing as our elected representatives seek new ways to ensure that whatever tax advice we receive is incorrect.”

“As a taxpayer, you are required to be fully in compliance with the United States Tax Code, which is currently the size and weight of the Budweiser Clydesdales.”

“Our tax code is so long it makes War and Peace seem breezy.”

 “[Tax law jurisprudence is] a field beset with invisible boomerangs.”

In following the recommendations of the Enron Compensation Report in enacting 409A, Congress added its own bizarre twists. Congress applied the Enron Compensation Report recommendations to every employer and every employee. The following chart reflects the Congressional extension.

<table>
<thead>
<tr>
<th>The Joint Tax Committee’s Information Was About</th>
<th>Congress Extended the Recommendations from the Joint Tax Committee to:</th>
</tr>
</thead>
<tbody>
<tr>
<td>One huge publicly traded company</td>
<td>Every employer including closely-held corporations, partnerships, and tax-exempt charitable organizations.</td>
</tr>
<tr>
<td>The top 200 executives at one huge publicly traded corporation</td>
<td>Every employee at every employer throughout the U.S.</td>
</tr>
<tr>
<td>Elective NQDC plans and supplemental NQDC plans(^\text{37}) that will pay hundreds of thousands of dollars (and in some)</td>
<td>Every arrangement in which amounts earned in the current year will be paid in a future year, including arrangements in</td>
</tr>
</tbody>
</table>

\(^{33}\) Yablon, supra note 1, at 113 (quoting Dave Barry).  
\(^{34}\) Id. at 147 (quoting Dave Barry).  
\(^{35}\) Id. at 113 (quoting Steven Latourette).  
\(^{36}\) Id. at 104 (quoting Robert H. Jackson).  
\(^{37}\) For a description of these types of plans see infra notes 44-47 and accompanying text.
cases millions of dollars) to one company’s highest-paid executives. which rank-and-file employees can defer a portion of their vacation to a future year.\textsuperscript{38}

A. The “Terrible Triple Tax” and Other Definitions.

Before analyzing the statute, a few key terms should be described.

\textbf{409A Authorities}. IRC § 409A, the regulations issued under the statute, the two technical corrections, the eight IRS Notices, and all the other governmental authorities interpreting 409A (including the preamble to the regulations, the legislative history, etc.).\textsuperscript{39}

\textbf{409A Plan Failure or 409A Violation}. Any situation in which an arrangement subject to 409A fails to satisfy the 409A requirements.

\textbf{Company}. Businesses taxed as corporations under Subchapter C of the Internal Revenue Code often use Traditional NQDC Plans to provide a benefit to their employees.\textsuperscript{40} As a result, this Article will refer to an entity creating and administering an NQDC plan as a “company.”

\textsuperscript{38} The IRC § 409A(d)(1) definition of “deferred compensation” excludes “bona fide vacation leave [or] sick leave . . . plans,” but the regulations fail to provide any guidance on when a taxpaying entity’s vacation or sick leave plan will be “bona fide.” See 72 Fed. Reg. at 19234. As a result, taxpaying entities will need to evaluate their vacation and sick leave plans based on the general principles of 409A. See Drennan, Goldstein, & Hussey, supra note 28, at 6 n.7.

\textsuperscript{39} See supra notes 3-4, and infra 317-20 and accompanying text regarding the 409A Authorities.

\textsuperscript{40} In contrast, partnerships, subchapter S corporations or LLCs taxed as partnerships, typically do not use Traditional NQDC Plans because in those situations there would be no income tax deferral. See Michael G. Goldstein, Michael Swirnoff and William A. Drennan, Taxation and Funding of Nonqualified Deferred Compensation: A Complete Guide to Design and Implementation, 213 (1999) [hereinafter Goldstein, Swirnoff & Drennan] (published by the Real Property, Probate and Trust Law Section of the American Bar Association) (“[O]ne of the primary purposes of NQDC – tax deferral for the employee – is not realized for an S corporation shareholder.”). \textit{Id.} at 214 (“As in the case of a NQDC plan which benefits all the shareholders of an S corporation, a NQDC plan for all the partners of a partnership will not provide the partners with a tax deferral.”). In the case of these pass-through entities, the owner will pay income tax (with Form 1040 in the case of an individual owner) automatically in the current year regardless of whether the entity distributes the cash to the individual. IRC § 701 (“A partnership as such shall not be subject to the income tax . . . . Persons carrying on business as partners shall be liable for income tax . . . in their . . . individual capacities.”). Similarly, an S corporation generally does not pay any income tax, IRC § 1363, and the individual shareholders pay the income tax on the amounts earned by the S corporation. IRC § 1366(a)(1).
Employee. 409A applies to NQDC arrangements for employees, but generally does not apply to NQDC arrangements for independent contractors. Despite the general exclusion of independent contractors, 409A applies to independent contractors who serve as corporate directors or who provide management services. This Article will refer to a participant in an NQDC arrangement as an “employee.”

Traditional NQDC Plans. Certain arrangements have historically been considered NQDC. In these Traditional NQDC Plans, the employee may voluntarily elect to defer a portion of his or her regular salary or bonus so that it will be paid in a future tax year.

EXAMPLE #1. EINSTEIN ELECTS TO DEFER COMPENSATION UNDER AN ELECTIVE ACCOUNT BALANCE TYPE OF NQDC PLAN. The Dilbert Cubicle Company (“Dilbert Co”) establishes a NQDC plan for certain employees, including Einstein. Under the plan, a participant can elect to voluntarily defer up to $10,000 of his or her regular salary each year. Dilbert Co will annually credit interest on the deferred amount at a government established interest rate. Dilbert Co will establish a bookkeeping account to keep track of each participant’s deferrals and the interest credited. The NQDC plan provides that payments will be made to the participant upon his or her retirement or other separation from service. The participant can elect (at the time of electing to make the initial deferral) whether his or her account balance...

42 Id.
44 See Goldstein, supra note 29, at 3. The 409A definition of deferred compensation can include other arrangements, such as vacation and sick leave policies, noncompete agreements and expense reimbursement arrangements. See Drennan, Goldstein & Hussey, supra note 28, at 6-8.
45 The government provides several interest rates that might be used, including the “applicable federal rates” under IRC § 1274(d)(1).
will be paid in a lump sum or in installments over a period of years. This NQDC plan can be described as a “Traditional NQDC Plan,” an “elective deferral plan,” or an “account balance plan.”

Alternatively, the company could voluntarily agree to defer supplemental compensation for the employee’s benefit. In these types of Traditional NQDC Plans, the employee does not make an election to defer.

**EXAMPLE #2.** DILBERT CUBICLE COMPANY ESTABLISHES A SUPPLEMENTAL NQDC PLAN FOR EINSTEIN AND OTHER EMPLOYEES. Dilbert Cubicle Company ("Dilbert Co") establishes an NQDC plan for certain employees, including Einstein. Under this plan, Dilbert Co agrees to pay an employee, after the employee attains age 65, an annual benefit equal to 2% of the employee’s average annual base salary (for the employee’s final five years of service) multiplied by the employee’s number of years of service. This NQDC plan can be described as a “Traditional NQDC Plan,” a “supplemental deferred compensation plan,” a “supplemental executive retirement plan” (also called a “SERP”), a “salary continuation plan,” or a “defined benefit plan.”

*Terrible Triple Tax.* If a 409A Plan Failure occurs, either because the plan document does not contain the necessary verbiage or the plan is not administered in accordance with 409A, the *employee* will be subject to three additional taxes. These three taxes collectively will be described as the “*Terrible Triple Tax.*” Part II.B(2) of this Article illustrates the application of the Terrible Triple Tax.

**B. Analyzing the Statutory Landscape in 12 Points.**

---

46 See also Goldstein, *supra* note 29, at 3 (using the phrase “‘true’ NQDC arrangements”).
47 *Id.* at 4.
Before descending into the labyrinth of the IRS’s NQDC regulations, it will be helpful to analyze the statute which the regulations interpret and implement.48 The statute (IRC § 409A) and its legislative history can be analyzed in a dozen aspects.

(1) **Pre-409A Income Tax Doctrines Survive.** A key goal in NQDC planning is to ensure that the employee is not subject to income tax on the compensation until it is actually paid to the employee. Prior to IRC § 409A, an employee could be taxed on NQDC before receiving the cash or property if the arrangement violated (i) the constructive receipt doctrine, (ii) the economic benefit doctrine, or (iii) IRC § 83.49 After 409A, these three provisions still apply.50 As a result, an employee can be taxed on a deferred amount before receiving the cash or property if the arrangement violates any of these three provisions, even if there is no 409A Plan Failure.

(2) **The Terrible Triple Tax the Employee Must Pay on a 409A Plan Failure.**

An NQDC plan violates 409A (i) if the written plan document does not include all the *magic verbiage* required by 409A;51 or (ii) if the plan is not operated in accordance with 409A.52 Upon a 409A Plan Failure, the employee must pay three separate taxes relating to the NQDC.

---

48 Congress directed the IRS to “prescribe such regulations as may be necessary or appropriate to carry out the purposes of [IRC § 409A].” IRC § 409A(e).
49 Methods for structuring NQDC arrangements to avoid these three rules are discussed in Goldstein, Swirnoff & Drennan, *supra* note 40, at 45-50
50 IRC § 409A(c); H.R. Conf. Rep. No. 108-755, *reprinted in* [2007] 7 Stand. Fed. Tax Rptr. (CCH) ¶18,952, at page 36,146 (“[409A] is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in [409A].”).
51 IRC § 409A(a)(1)(A)(i)(I). For examples of 409A violations triggered by the failure to use magic verbiage, see Examples 12 through 14 of this Article. Also, any NQDC plan that is not in writing, or has not been “adopted,” will automatically violate 409A and trigger the Terrible Triple Tax. Treas. Reg. § 1.409A-1(c)(3)(i) (2007) (“A plan does not satisfy the requirements of section 409A . . . unless the plan is established and maintained by [an employer] in accordance with the requirements of this section . . . . [a] plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing.”) (emphasis added).
52 IRC § 409A(a)(1)(A)(i)(II).
• **FIRST TAX LIABILITY.** All compensation deferred under the plan, in prior years and the current year, must be included in the employee’s gross income in the year of the 409A Plan Failure. All these amounts will be taxable in the year of the 409A Plan Failure even if the employee will not receive any cash or property from the plan for many years.

**EXAMPLE #3. BASIC EINSTEIN EXAMPLE.** Einstein is 50 years old and works for the Dilbert Cubicle Company (“Dilbert Co”). Under a Traditional NQDC Plan, Einstein has deferred $5,000 of his salary every year for 10 years (from 2000 through 2009), and the deferred amounts (plus interest based on a fixed rate) will be paid to Einstein when he turns 65 (or upon his death or permanent disability before age 65). Dilbert Co amends the NQDC plan in 2009,\(^5\) all amounts deferred are subject to 409A, and the plan as amended does not contain the magic verbiage. As a result of this 409A Plan Failure, Einstein must include the entire amount deferred ($50,000), and all accrued interest on the deferred amounts (assume the accrued interest is $20,000), in his gross income all in 2009.\(^5\) Einstein will owe additional tax because of the 409A Plan Failure, and to make matters worse, Einstein has no right to receive any cash from the NQDC plan for 15 years (unless he dies or becomes permanently disabled before attaining age 65).\(^5\) Thus, Einstein owes extra income taxes because of 409A, and has no extra cash to pay the tax.

---

\(^5\) Many NQDC plans were amended in 2008 because the IRS offered taxpayers one last chance to amend the time and form of payment of NQDC benefits free of the 409A limitations. Those amendments had to be made before 2009. See IRS Notice 2007-86, § 3.02, 2007-46 I.R.B. 990 (Oct. 22, 2007).

\(^5\) Amounts deferred before 2005 will become subject to 409A if there is a material modification of the plan which impacts those deferrals. See infra notes 297-305 and accompanying text.

\(^5\) IRC § 409A(a)(1)(A). This example assumes the 2009 amendment to the NQDC plan is a material modification that impacts pre-2005 deferrals. As a result, there is a 409A Plan Failure with respect to all amounts deferred under the plan.

\(^5\) In this situation, the Dilbert Cubicle Company could voluntarily elect to make a payment to Einstein up to the amount that Einstein must include in his gross income ($70,000). See Treas. Reg. § 1.409A-3(j)(4) (2007) (providing that an employer has discretion to accelerate payments in certain situations); id. § 1.409A-3(j)(4)(vii) (2007) (providing a limited exception for amounts included in gross income under IRC § 409A). Also, the Dilbert Cubicle Company could have provided in the plan document for an automatic payment in this situation equal to the amount included in gross income under 409A. See Treas. Reg. § 1.409A-3(j)(4)(i) (2007). In Example #3, it is assumed that the plan document does not provide for an automatic cash distribution upon a 409A Plan Failure.
• **SECOND TAX LIABILITY.** The employee must pay an extra tax equal to 20% of the amount included in gross income as a result of the 409A Plan Failure.\(^{57}\)

**EXAMPLE #4.** Same as Example #3. As a result of this 20% rule, Einstein will owe an extra $14,000 in income taxes for 2009.\(^{58}\)

• **THIRD TAX LIABILITY.** The employee must pay a *third tax* for the year of the Plan Failure equal to “the amount of interest . . . [on] the [tax] underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred . . .”\(^{59}\)

**EXAMPLE #5.** Same as Examples #3 and #4. Einstein will owe a third tax of approximately $7,600 in 2009 because of the extra tax based on the interest calculation.\(^{60}\)

\(^{57}\) IRC § 409A(a)(1)(B)(i)(II).

\(^{58}\) The 20% extra tax even applies to the amount Einstein deferred in 2009. IRC § 409A(a)(1)(A) provides that “[A]ll compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year [of the 409A Plan Failure].” In addition, although the IRS has not issued regulations on the calculation of the Terrible Triple Tax, see Treas. Reg. § 1.409A-4 (2007) [reserved by the IRS], the 20% extra tax likely applies to both the amounts deferred and the earnings accrued under the NQDC plan. See Treas. Reg. § 1.409A-1(b)(2) (2007).

\(^{59}\) IRC § 409A(a)(1)(B)(ii). “[T]he interest determined under this clause for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point . . . .” Id.

\(^{60}\) **EINSTEIN EXAMPLE – TERRIBLE TRIPLE TAX**

<table>
<thead>
<tr>
<th>(1) Year</th>
<th>(2) Amount Deferred</th>
<th>(3) Interest Accrued on NQDC Balance During the Year (sum of col. 4 for all prior years) x 7%*</th>
<th>(4) NQDC Account Increase for the Year</th>
<th>(5) Additional Tax on Increased Deferral (col. 4) x Income Tax Rate for 2009 (35%) **</th>
<th>(6) Interest at 8% on Tax Underpayment in col. (5), from the year in col. (1) to 2009***</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>$5,000</td>
<td>- 0 -</td>
<td>$5,000</td>
<td>$1,750</td>
<td>$1,260</td>
</tr>
<tr>
<td>2001</td>
<td>$5,000</td>
<td>$350</td>
<td>$5,350</td>
<td>$1,872</td>
<td>$1,198</td>
</tr>
</tbody>
</table>
In this situation, Einstein deferred a total of $50,000 ($5,000 per year from 2000 through 2009). As a result of the Terrible Triple Tax, Einstein owes additional federal income tax of $45,800 in 2009, and he has no right to receive any cash from the NQDC plan for 15 years. Thus, the additional tax liability triggered by a 409A Plan Failure can approach the amount of compensation deferred under the NQDC plan.\textsuperscript{61} If relatively substantial amounts were deferred in earlier years, the amount of the Terrible Triple Tax can exceed the total amount deferred.\textsuperscript{62}

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Deflected</th>
<th>Interest Earned</th>
<th>Total Amount</th>
<th>Federal Income Tax</th>
<th>Additional Tax due to 409A Plan Failure</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$5,000</td>
<td>$724</td>
<td>$5,724</td>
<td>$2,003</td>
<td>$1,122</td>
</tr>
<tr>
<td>2003</td>
<td>$5,000</td>
<td>$1,125</td>
<td>$6,125</td>
<td>$2,144</td>
<td>$1,029</td>
</tr>
<tr>
<td>2004</td>
<td>$5,000</td>
<td>$1,554</td>
<td>$6,554</td>
<td>$2,294</td>
<td>$918</td>
</tr>
<tr>
<td>2005</td>
<td>$5,000</td>
<td>$2,013</td>
<td>$7,013</td>
<td>$2,455</td>
<td>$786</td>
</tr>
<tr>
<td>2006</td>
<td>$5,000</td>
<td>$2,503</td>
<td>$7,503</td>
<td>$2,626</td>
<td>$630</td>
</tr>
<tr>
<td>2007</td>
<td>$5,000</td>
<td>$2,997</td>
<td>$7,997</td>
<td>$2,799</td>
<td>$448</td>
</tr>
<tr>
<td>2008</td>
<td>$5,000</td>
<td>$3,589</td>
<td>$8,589</td>
<td>$3,006</td>
<td>$240</td>
</tr>
<tr>
<td>2009</td>
<td>$5,000</td>
<td>$4,190</td>
<td>$9,190</td>
<td>$3,216</td>
<td>- 0 -</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$50,000</td>
<td>$19,045</td>
<td>$69,045</td>
<td>$24,165</td>
<td>$7,631</td>
</tr>
</tbody>
</table>

*This example assumes that Einstein’s account balance earns interest at the rate of 7% annually.
** This example assumes that the maximum income tax rate for 2009 is 35%.
*** The additional tax owed under IRC § 409(a)(1)(B)(ii) is calculated in this example assuming an 8% interest rate.

In this example, Einstein would owe additional income tax of approximately $45,605 for 2009 because of the 409A Plan Failure. First, the deferred amounts plus interest are included in his 2009 gross income under IRC § 409A(a)(1)(A), which triggers a tax liability of approximately $24,165 (see column (5) in the chart). Second, Einstein owes an extra $13,809 because of the 20% tax under IRC § 409A (a)(1)(B)(i)(II) [$69,045 x 20% = $13,809]. Third, Einstein owes an extra tax of $7,631 based on the interest calculation of IRC § 409A(a)(1)(B). Thus, Einstein voluntarily deferred $50,000, and because of the 409A Plan Failure, he owes extra tax in 2009 of approximately $45,800 [$24,165 + $13,809 + $7,631 = $45,605]. \textsuperscript{61} In Examples #3, #4, and #5, no amount was paid to Einstein, although the company would have discretion to make a payment. See infra notes 182-85 and accompanying text.

\textsuperscript{62} This could occur if the employee deferred substantial amounts in earlier years, because in that situation the extra tax based on the interest calculation would be substantial.

**EINSTEIN EXAMPLE – TERRIBLE TRIPLE TAX EXCEEDS 100% OF THE ORIGINAL COMPENSATION DEFERRED**
(3) Defining NQDC. “The term ‘nonqualified deferred compensation plan’ means any plan that provides for the deferral of compensation.” 409A provides exceptions for:

- qualified plans, such as 401(k)’s, qualified profit-sharing plans, and qualified pension plans;
- 457(b) plans (established by tax-exempt organizations); and

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Deferred</th>
<th>Interest Accrued on NQDC Balance During the Year (sum of col. 4 for all prior years) x 5%**</th>
<th>NQDC Amount Increase for the Year</th>
<th>Additional Tax on Increased Deferral (col. 4) x Income Tax Rate for 2009 (35%)</th>
<th>Interest (at 8%) on Tax Underpayment in col. 5, from the Year in col. 1 to 2009 ***</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>$20,000</td>
<td>- 0 -</td>
<td>$20,000</td>
<td>$7,000</td>
<td>$5,040</td>
</tr>
<tr>
<td>2001</td>
<td>$20,000</td>
<td>$1,000</td>
<td>$21,000</td>
<td>$7,350</td>
<td>$4,704</td>
</tr>
<tr>
<td>2002</td>
<td>$20,000</td>
<td>$2,050</td>
<td>$22,050</td>
<td>$7,717</td>
<td>$4,322</td>
</tr>
<tr>
<td>2003</td>
<td>$20,000</td>
<td>$3,153</td>
<td>$23,153</td>
<td>$8,104</td>
<td>$3,890</td>
</tr>
<tr>
<td>2004</td>
<td>$5,000</td>
<td>$4,310</td>
<td>$9,310</td>
<td>$3,259</td>
<td>$1,304</td>
</tr>
<tr>
<td>2005</td>
<td>$5,000</td>
<td>$4,776</td>
<td>$9,776</td>
<td>$3,422</td>
<td>$1,095</td>
</tr>
<tr>
<td>2006</td>
<td>$5,000</td>
<td>$5,264</td>
<td>$10,264</td>
<td>$3,592</td>
<td>$862</td>
</tr>
<tr>
<td>2007</td>
<td>- 0 -</td>
<td>$5,778</td>
<td>$5,778</td>
<td>$2,022</td>
<td>$324</td>
</tr>
<tr>
<td>2008</td>
<td>- 0 -</td>
<td>$6,067</td>
<td>$6,067</td>
<td>$2,124</td>
<td>$170</td>
</tr>
<tr>
<td>2009</td>
<td>- 0 -</td>
<td>$6,370</td>
<td>$6,370</td>
<td>$2,230</td>
<td>- 0 -</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$95,000</td>
<td>$38,768</td>
<td>$133,768</td>
<td>$46,820</td>
<td>$21,711</td>
</tr>
</tbody>
</table>

*In this example, Einstein defers $20,000 in each of the first four years (2000-2003). He defers only $5,000 in each of the next three years (2004-2006). He elects not to defer after 2006.

**Einstein’s account balance earns interest at the rate of 5% annually.

*** The additional tax owed under IRC § 409A(a)(1)(B)(ii) is calculated assuming an 8% interest rate (with no compounding).

In this example, Einstein owes tax of approximately $46,820 under IRC § 409A(a)(1)(A) (see column (5), plus an extra tax of $26,754 because of the 20% tax under IRC § 409A(a)(1)(B)(i)(II) ($133,768 x 20% = $26,754), plus a third tax of $21,711 based on the interest calculation of IRC § 409A(a)(1)(B). In this example, Einstein deferred $95,000 (the sum of the amounts in column 1), but he owes extra tax because of the 409A Plan Failure of $95,285 ($46,820 + $26,754 + $21,711 = $95,285).

63 IRC § 409A(d)(1).
• “any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan[s].”

The legislative history provides exceptions for:

• qualified stock options;

• nonqualified stock options (if the exercise price was not below the market price when the option was issued); and

• compensation paid within 2 ½ months of the end of the year in which the compensation was deferred.

(4) **Defining a “Plan.”** 409A defines the term “plan” as “any agreement or arrangement, including an agreement or arrangement that includes one person.”

(5) **Effective Date.** 409A applies to amounts that were earned, deferred or became vested in taxable years after December 31, 2004. In addition, 409A will apply to any pre-2005 deferrals (including any NQDC plan in which no amounts were deferred after 2004), if there is a “material modification” of the plan after October 3, 2004 which impacts those deferrals. Earnings on deferred compensation subject to 409A are also subject to 409A.

(6) **Timing of Deferral Elections.** Frequently under Traditional NQDC Plans, the employee elects to defer compensation (such as salary or bonus amounts) that the company otherwise would pay in the current year. A 409A Plan Failure generally will

---

64 *Id.* § 409A(d)(1)(B) (emphasis added).
66 IRC § 409A(d)(3).
69 *Id.*
70 In other NQDC arrangements, the employer provides supplemental compensation to the employee. See Goldstein, Swirnoff & Drennan, *supra* note 40, at 88 (describing “nonaccount balance plans”). *See supra* Example #2.
occur unless the employee must make the election before the beginning of the tax year in which he or she will earn the compensation.\footnote{\textbf{71}}

409A provides the employee with extra time to make an election to defer \textit{performance-based compensation}. If the amount of compensation is “contingent on pre-established organizational or individual performance criteria relating to a performance period of at least 12 consecutive months,”\footnote{\textbf{72}} the employee can elect to defer “on or before the date that is six months before the end of the performance period.”\footnote{\textbf{73}} For example, if the company will pay a bonus to the employee based on the company’s performance during the calendar year 2010, the employee is \textit{not} required to make the deferral election by December 31, 2009; instead, the employee can make the deferral election as late as June 30, 2010.\footnote{\textbf{74}} The IRS regulations impose additional restrictions on the use of this exception.\footnote{\textbf{75}}

The following examples may help demonstrate the practical impact of several 409A provisions.

\textbf{EXAMPLE #6}. As in Example #3, Einstein works for the Dilbert Cubicle Company, a corporation taxed under Subchapter C of the Internal Revenue Code. Einstein has been voluntarily deferring $5,000 per year under the company’s NQDC plan for 10 years (from 2000 through 2009). The NQDC plan allows employees to voluntarily defer a portion of their salary each year, and the corporation maintains a bookkeeping account to keep track of the amounts deferred and the earnings credited to the deferred amounts. Thus, Dilbert Co’s NQDC plan is an account balance plan allowing elective deferrals and is \textit{not} a defined benefit plan providing supplemental compensation.\footnote{\textbf{76}}

\textbf{APPLICATION OF THE 409A ELECTION RULES}

\footnote{\textbf{71}} IRC § 409A(a)(4)(B)(i).
\footnote{\textbf{74}} IRC § 409A(a)(4)(B)(iii).
\footnote{\textbf{75}} An important restriction is that the amount of the performance-based compensation cannot be “readily ascertainable” at the time the election is made. Treas. Reg. § 1.409A-2(a)(8) (2007).
\footnote{\textbf{76}} \textit{See} Goldstein, Swirnoff & Drennan, \textit{supra} note 40, at 87 (discussing account balance plans); \textit{id}. at 88 (discussing nonaccount balance plans).
TO THE EINSTEIN EXAMPLE:

EXAMPLE #7. As a result of 409A, in Example #6, Einstein will need to irrevocably elect the amount he wants to defer from his 2010 salary on or before December 31, 2009. If the Dilbert Cubicle Company allows Einstein to defer a portion of his bonus for 2010 (which will be based on the company’s financial performance from January 1 through December 31 of 2010), Einstein will not need to make the irrevocable election to defer a portion of his bonus until June 30, 2010.77

(7) Prohibiting Accelerations and Restricting Payments. The Joint Tax Committee sharply criticized a provision in Enron’s NQDC plan, which is commonly referred to as a “haircut” provision.78 Under a haircut provision, an employee can request that the company pay all or part of his or her accrued NQDC benefit before the amount otherwise would be paid under the terms of the NQDC plan. If the company agrees to pay early, the company pays a discounted amount. For example, if the NQDC plan includes a 10% haircut provision and the employee’s accrued NQDC benefit is $100,000, and the employee and the company agree to a haircut payment of the entire account balance, the company will promptly pay the employee $90,000 (less customary tax withholding). The employee forfeits $10,000, which is the “haircut.” As Enron approached bankruptcy, 181 executives requested their NQDC money (minus the haircut), and Enron granted the requests for 109 executives.79

The Joint Tax Committee criticized this haircut provision, arguing that it permitted the parties to control the timing of the NQDC payments.80 IRC § 409A(a)(3) follows the recommendation from the Enron Compensation Report and generally

77 IRC § 409A(a)(3).
78 Enron Compensation Report, supra note 17, at 608.
79 Id. at 611, 622-5.
80 Id. at 634-35; id. at 20 (“Changes should be made to the rules relating to nonqualified deferred compensation arrangements to curb current practices that allow for the deferral of tax on compensation income while providing executives with inappropriate levels of security, control and flexibility with respect to deferred compensation.”).
prohibits acceleration of payments under an NQDC plan. After 2008, even if both the company and the employee agree that NQDC amounts should be paid to the employee before the scheduled date under the NQDC plan, such an acceleration will trigger a 409A Plan Failure and the Terrible Triple Tax. IRC § 409A(a)(3) allows the IRS to make exceptions, and the final IRS regulations contain 13 exceptions. This Article discusses the 13 exceptions in analyzing the regulations.

In a major change from prior law, a plan subject to 409A can only permit NQDC benefits to be paid at a specified time or under a fixed schedule established before or at the time the compensation was deferred, or upon the occurrence of one or more of the following five “permissible payment” events:

- death;
- disability;
- separation from service;
- the occurrence of an unforeseeable emergency; or
- a change in the ownership or effective control of the company, or the ownership of a substantial portion of the company’s assets.

---

81 Under IRS Notice 2007-86, § 3.02, 2007-46 I.R.B. 990 (Oct. 22, 2007), an employer may permit an employee to elect to change the time and form of payment until December 31, 2008, subject to various conditions, without triggering a 409A Plan Failure.

82 See infra Part IV.

83 Goldstein, Swirnoff & Drennan, supra note 40, at 57-58 (discussing prior law).

84 The treasury regulations provide:

Amounts are payable at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred. An amount is objectively determinable . . . if the amount is specifically identified or if the amount may be determined at the time payment is due pursuant to an objective, nondiscretionary formula specified at the time the amount is deferred (for example, 50 percent of a specified account balance).


85 IRC §409A(a)(2)(A). The term “permissible payment event” refers to any one of these five events. See Treas. Reg. § 1.409A-3(b) (2007).
Wickedly complex rules determine when any of these “permissible payment” events occur.\footnote{86}{See infra Part V of this Article.} Prior law permitted many other payment events.\footnote{87}{Goldstein, Swirnoff & Drennan, supra note 40, at 57-58.}

**APPLYING THE “PERMISSIBLE PAYMENT” EVENT RESTRICTIONS TO THE EINSTEIN EXAMPLE:**

**EXAMPLE #8.** In originally designing its Traditional NQDC Plan in 2000, the Dilbert Cubicle Company followed IRS rulings and provided that payments would be made to an employee if (i) the employee switched from full-time employment to part-time employment; (ii) the employee ceased being a director of the company;\footnote{88}{See Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 64-279, 1964-2 C.B. 121, and Rev. Rul. 70-435, 1970-2 C.B. 100.} or (iii) the company’s net worth fell below $10 million.\footnote{89}{Priv. Ltr. Rul. 95-08-014 (Nov. 22, 1994) (“The plan automatically terminates if the Company’s net worth falls below $10,000,000”). A copy of the NQDC plan considered in that IRS ruling is reprinted in 24 Tax Mgm’t. Compensation Planning J., 9 (Jan. 5, 1996) (section 7.3 of the plan document).} Under IRC § 409A, none of these events would be a permissible payment event. As a result, before 2009 the company must amend the plan document by deleting all of these payment triggers for amounts subject to 409A, or a 409A Plan Failure occurs.\footnote{90}{This assumes that 409A applies to the amounts deferred. IRC § 409A applies to pre-2005 deferrals if a material modification of the plan after October 3, 2004 impacts those deferrals. See infra notes 294-305 and accompanying text.}

**Subsequent Deferral Rules.** Under 409A, once the company and/or the employee defer an amount, they can only defer it again if:

- They make the subsequent election or agreement to defer at least 1 year before the company otherwise would be obligated to pay the amount;
- The subsequent election or agreement to defer is not effective for at least 1 year; and
- The amount is deferred for at least an additional 5 years.\footnote{91}{IRC § 409A(a)(4)(C)(i)-(iii).}

Before 409A, several court cases concluded that the company and the employee could enter into a bona fide agreement shortly before the company was scheduled to pay an NQDC benefit, and the subsequent deferral agreement would successfully defer the employee’s income tax liability until the company actually paid the NQDC benefit to the employee.\footnote{86}{See infra Part V of this Article.}
employee.\textsuperscript{92} Also, the American Bar Association argued that an employee should have the unilateral right to elect to change the time or form of payment at least six months before an amount would otherwise be paid, and that election could further defer the employee’s income tax liability.\textsuperscript{93} These types of agreements or provisions would now violate 409A.

APPLYING THE SUBSEQUENT DEFERRAL RULE
TO THE EINSTEIN EXAMPLE

EXAMPLE #9. The Dilbert Cubicle Company’s NQDC plan provides that payments will begin when the employee attains age 65. Six months before turning 65, the Company talks Einstein into continuing to work full-time for the Company for another two years. Because Einstein will not need the NQDC payments while he is working full-time, the parties would like to agree that no NQDC payments will be made to Einstein until he turns 67. Such an agreement created no income tax problem for the employee under old law, but will trigger the 409A Terrible Triple Tax today.

(9) **Substantial Risk of Forfeiture.** Traditionally, an employee would not be subject to income tax on a right to receive payments if there was a substantial risk that the employee would forfeit the benefit.\textsuperscript{94} Before 409A, an IRS example provided that an obligation to work at least two years for a company to receive a benefit would be a substantial risk of forfeiture.\textsuperscript{95} Another pre-409A IRS example demonstrated that an obligation to refrain from competing for five years could create a substantial risk of


\textsuperscript{94} IRC § 83(a).

\textsuperscript{95} Treas. Reg. § 1.83-3(c)(4) (Example #1) (1978).
forfeiture. Generally, IRC § 409A(a)(1)(A)(i) provides that a 409A Plan Failure will not occur as long as the employee’s right to receive the NQDC is subject to a “substantial risk of forfeiture.”

However, 409A grants the IRS authority to “disregard . . . a substantial risk of forfeiture in cases where necessary to carry out the purposes of [IRC § 409A].” As discussed in Part VI.A of this Article, the IRS has applied this power so broadly that aspects of the IRS regulations may contradict the approach taken in the statute, and should be invalid.

**DISREGARDING A SUBSTANTIAL RISK OF FORFEITURE IN THE EINSTEIN EXAMPLE:**

**EXAMPLE #10.** Einstein voluntarily elects to defer part of his salary every year. Assume that the NQDC plan states that Einstein will forfeit his entire NQDC benefit if he quits, or is terminated for cause, before attaining age 65. Based on a plain reading of 409A, Einstein’s NQDC benefits are subject to a substantial risk of forfeiture. However, the IRS regulations disregard this forfeiture provision because Einstein elected to defer the compensation.

(10) **Aggregation Rules.** As discussed in Part VII.C.4 of this Article, IRC § 409A(a)(2)(A)(i) permits distributions to an employee upon his or her “separation from service.” But what if the service provider immediately goes to work for an affiliated

---

96 *Id.* (Example #5).
97 IRC § 409A(e)(5).
98 *See infra* notes 278-86 and accompanying text.
99 For an NQDC arrangement involving this type of a risk of forfeiture, see IRS Priv. Ltr. Rul. 93-17-010 (Jan. 22, 1993).
100 IRC § 409A(a)(1)(A) basically provides that the Terrible Triple Tax will apply if there is a 409A Plan Failure, unless the NQDC is subject to a substantial risk of forfeiture. IRC § 409A(d)(4) provides that “[t]he rights of a person to compensation are subject to a substantial risk of forfeiture if such person’s rights . . . are conditioned upon the future performance of substantial services by any individual.”
101 Treas. Reg. § 1.409A-1(d)(1) (2007) (“For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture.”); *see infra* notes 279-83 and accompanying text.
IRC § 409A(d)(6) applies the aggregation rules of IRC § 414(b) and (c) so that the two affiliated employers could be treated as one entity for these purposes. As a result, the employee would not have a “separation from service,” and the employee would not begin receiving NQDC payments.

(11) Reporting Requirements. In connection with the enactment of 409A, IRC § 6051(a)(13) was added to require that the employee’s W-2 (or the independent contractor’s 1099) include the amount deferred during the year, even if the employee has not been taxed on that amount. Because 409A treats earnings on deferred amounts as NQDC, the earnings on the deferred amounts may need to be reported.

(12) Amended Plans. The legislative history anticipates that employers will amend pre-2005 NQDC plans to comply with 409A if compensation was deferred after December 31, 2004.

C. Exceptions from 409A.

Section 409A defines deferred compensation broadly. The statute contains two disturbing exclusions.

102 This would happen if the employee terminates employment with the parent corporation, and goes to work for the parent’s wholly-owned subsidiary corporation.
103 IRC § 409A only applies to an independent contractor’s NQDC if the independent contractor is a director, or provides management services. See supra notes 41-43 and accompanying text.
104 P.L. No. 108-357, § 885(b)(1)(A); see also H.R. Conf. Rep. No. 108-755, reprinted in [2007] 7 Stand. Fed. Tax Rptr. ¶18,952, at page 36,147 (“Such amounts are required to be reported on an individual’s Form W-2 (or Form 1099) for the year deferred even if the amount is not currently includible in income for that taxable year.”).
105 IRC § 409A(d)(5); Treas. Reg. § 1.409A-1(b)(2) (2007) (“References to the deferral of compensation or deferred compensation include references to earnings.”).
107 IRC § 409A(d)(1). The statute provides an additional exception for short-term deferrals. This exception applies when the deferral period is 2 ½ months or less. Treas. Reg. §1.409A-1(b)(4) (2007). The amount must be paid “within 2 ½ months after the close of the taxable year in which the relevant services . . . have been performed.” H.R. Conf. Rep. No. 108-755, reprinted in [2007] 7 Stand Fed. Tax Rptr. (CCH) at ¶18,952, at page 36,146 (emphasis added). This exception applies when the company will pay a bonus by
1. *The Extremely Disappointing Stock Option Exception.*

The Enron Compensation Report revealed that the top executives used a stock option plan to fleece the company.\(^\text{108}\) Stock options grant the employee complete control over the receipt of the benefit – at any time he or she can pay the price to exercise the option and immediately receive the income.\(^\text{109}\)

Nevertheless, the 409A legislative history and final regulations instruct corporations and their top executives on how to structure stock options to avoid 409A. 409A provides exceptions for qualified (incentive) stock options described in IRC § 422,\(^\text{110}\) and employee stock purchase plans described in IRC § 423.\(^\text{111}\) More important, 409A exempts nonqualified stock options as long as the exercise price “is not less than the fair market value of the underlying stock on the date of grant . . . .”\(^\text{112}\) The IRS preamble states, “there are no . . . . limits applicable to nonstatutory stock options.”\(^\text{113}\) The regulations provide detailed rules that apply if an option plan fails to meet the exception.\(^\text{114}\)

2. *The Professional Golfer Exception – A Hole-in-One by the PGA’s Lobbyist!*

March 15th based on the company’s performance during the previous calendar year. The exception will be available even if the company fails to make the payment within the 2 ½ month period if the delay was caused by the company’s insolvency, or if making the payment would jeopardize the ability of the company to continue as a going concern, or it was “administratively impractical to make the payment by the end of the applicable 2 ½ month period . . . .” Treas. Reg. § 1.409A-1(b)(4)(ii) (2007).

\(^{108}\) *See supra* note 14.

\(^{109}\) The ability to exercise would be subject to any restrictions contained in the stock option plan document.

\(^{110}\) A company can issue only a limited amount of incentive stock options each year. *See* IRC § 422(d)(1) (“To the extent that the aggregate fair market value of stock with respect to which incentive stock options . . . are exercisable for the first time by any individual during any calendar year . . . exceeds $100,000, such options shall be treated as options which are not incentive stock options.”).


\(^{113}\) 72 Fed. Reg. at 19240.

A review of 409A would not be complete without a round of applause for a remarkable achievement by the lobbyists for the Professional Golfers Association. Thanks to Section 885(d)(3) of the American Jobs Creation Act of 2004, Tiger, Phil, Ernie, Retief, Sergio and all the other pro golfers can ignore 409A and concentrate on their drives, pitches, chips, and puts. The legislative history states:

[409A] does not apply to a plan meeting the requirements of [IRC §] 457(e)(12) if the plan was in existence as of May 1, 2004, was providing nonelective deferred compensation described in section 457(e)(12) on such date, and is established or maintained by an organization incorporated on July 2, 1974.116

Apparently the NQDC plan for the Professional Golfers Association meets all these requirements. Thus, while small businesses and charities everywhere will worry about 409A, they can all take great satisfaction in knowing that their government has shielded Tiger from these provisions.

III. REGULATION OF ELECTIONS TO DEFER COMPENSATION

“I have no idea what was in my federal tax return. Like 93 percent of all U.S. taxpayers, I just sign it and send it in. For all I know, it states that I am a professional squid wrangler.”118

“I shall never use profanity except in discussing house rent and taxes.”119

117 See Joe Logan, Corporate Relief Plan Takes Hazard Out of Play for Top Pros, Philadelphia Inquirer, Oct. 27, 2004 (“If weekend hack golfers needed any more reason to be envious of PGA Tour players, they can now be jealous of their pension plans.”).
118 Yablons, supra note 1, at 146 (quoting Dave Barry). “Nuclear physics is much easier than tax law. It’s rational and always works the same way.” Id. at 142 (quoting Jerold Rochwald).
119 Id. at 109 (quoting Mark Twain).
“I hold in my hand 1,379 pages of tax simplification.”

“In my own case the words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession; cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of – leave in my mind only a confused sense of some vitally important, but successfully concealed, [purpose] . . . .”

The IRS spent over three years developing regulations to implement 409A. The IRS issued a 91-page preamble and final regulations package, two sets of technical corrections, and eight Notices. Section 409A regulates every step of the NQDC process, including the employee’s initial election to defer compensation.

A. Timing Regulation for Initial Elections to Defer.

A series of court cases stretching back over 60 years established that an employee could elect to defer compensation even after the employee had performed the services and earned the compensation, as long as the amount was not yet payable. As a result, before 409A, employers and employees could be flexible in designing and administering an employee’s election to defer the payment of compensation. Congress effectively reversed those cases by enacting IRC § 409A(a)(4)(B)(i), which provides that a 409A

---

120 Id. at 130 (quoting Delbert L. Latta).
121 Id. at 111 (quoting Learned Hand).
124 See supra note 4.
Plan Failure occurs if the employee elects to defer compensation after the year has begun.  

The Treasury Regulation requires that the election be irrevocable before the year begins. The regulations provide an exception so that in an employee’s first year of eligibility, the employee can elect to defer compensation within 30 days of becoming eligible. The Treasury Regulations set forth a plethora of quirky rules regarding:

<table>
<thead>
<tr>
<th>Performance-Based Compensation</th>
<th>When compensation is “contingent on the satisfaction of pre-established organizational or individual performance criteria relating to a performance period of at least 12 consecutive months” and the criteria are established in writing no “later than 90 days after the commencement of the period of service to which the criteria relates,” the amount is “performance-based compensation.” The election to defer performance-based compensation can be made “before the date that is six months before the end of the performance period,” and before the amount is “calculable and substantially certain to be paid . . .”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-Term Deferrals</td>
<td>If in the absence of the election the amount would qualify as a short-term deferral, an initial election may be made in the same manner as a “subsequent election,” and the potential</td>
</tr>
</tbody>
</table>

---

126 See also Treas. Reg. §1.409A-2(a)(3) (2007) ("A plan . . . meets the requirements of section 409A(a)(4)(B) if under the terms of the plan, compensation for services performed during [an employee’s] taxable year . . . may be deferred at the [employee’s] election only if the election to defer such compensation is made not later than the close of the [employee’s] taxable year next preceding the service year.") As a technical matter, one could argue that the cases which allowed deferral agreements until an amount becomes payable, see supra note 125 (citing Veit, Oates and Martin), were decided under the construction receipt doctrine, and because 409A does not abolish the construction receipt doctrine, 409A does not reverse those cases. However, as a practical matter, IRC § 409A(a)(4)(B)(i) effectively reverses those cases because an election to defer after the beginning of the year will trigger a 409A Plan Failure, and the application of the Terrible Triple Tax.


128 Id. § 1.409A-2(a)(7)(i). However, the employee cannot elect to defer any compensation earned before she makes the election. If a newly-eligible participant elects to defer an annual bonus, the employee can only defer a portion of the annual bonus which is equal to the amount of the bonus “multiplied by the ratio of the number of days remaining in the performance period after the election, over the total number of days in the performance period.” Id.

129 Id. § 1.409A-1(e)(1).

130 Id. § 1.409A-2(a)(8) (emphasis added.)

131 An amount is not treated as NQDC if the employee “actually or constructively receives such payment [within] 2-1/2 months [of the end of the year].” Id. § 1.409A-1(b)(4)(i). This is referred to as the exception for short-term deferrals. Id.

132 See infra notes 140-48 and accompanying text.
| Certain Forfeitable Rights | If the employee’s right to the amount is “subject to a condition requiring the [employee] to provide services for a period of at least 12 months,” the election to defer “may be made on or before the 30th day after the [employee] obtains the legally binding right to the compensation [and] at least 12 months in advance of the earliest date at which the forfeiture condition could lapse.”  

<sup>133</sup> |  

| Fiscal Year Compensation | If the employee is on a calendar year and the company is on a fiscal year, the NQDC “plan may provide that [the employee may elect] . . . not later than the close of the company’s taxable year immediately preceding the first taxable year of the [company] in which any services are performed for which such compensation is payable.”  

<sup>135</sup> |  

| Sales Commissions | A salesperson is deemed to provide services in the “taxable year in which the customer remits payment . . . or, if applied consistently to all similarly situated [employees] the . . . taxable year in which the sale occurs.”  

<sup>136</sup> |  

| Investment Commission Compensation | The employee “is treated as providing the services . . . over the 12 months preceding the date as of which the overall value of the assets or asset accounts is determined for purposes of the calculation of the investment commission compensation.”  

<sup>137</sup> |  

---

**B. Timing Regulation for Subsequent Elections to Defer Compensation.**

For 60 years, case law supported the freedom of an employer and employee to mutually agree to defer an amount that had previously been deferred, as long as the

---

<sup>134</sup> Id. § 1.409A-2(a)(5) (2007).  
<sup>135</sup> Id. § 1.409A-2(a)(6).  
<sup>136</sup> Id. § 1.409A-2(a)(12).  
<sup>137</sup> Id. § 1.409A-2(a)(12)(ii). The regulation includes a detailed definition of “investment commission compensation.” *Id.*
amount was not yet payable. The American Bar Association tried to push the envelope even further; arguing that an employee should have the right to elect to extend a payment at any time as long as the subsequent election would be made at least six months before the amount otherwise would be paid.

409A greatly restricts the ability to extend a payment date. If a plan document permits subsequent deferrals, a 409A Plan Failure will automatically occur unless the language of the plan satisfies three key requirements:

- The subsequent election to defer must be made “at least 12 months [before] the date of the first scheduled payment . . . .”
- The subsequent election to defer cannot take effect for 12 months.
- “The payment . . . [must be deferred] for [at least] 5 years from the date such payment would otherwise have been made . . . .”

This three-part general rule may come to be known as the 1-year/1-year/5-year rule.

The 5-year requirement is satisfied even if the amount would be paid upon the employee’s death or disability (or if the employee has an unforeseeable financial need). Specifically, in *Veit v. Commissioner*, 8 T.C.M. (CCH) 919 (1949), the employee and employer entered into an agreement in which the employee would receive 10% of the corporation’s profits for two years as compensation, and the amount for the second year would be paid in four quarterly installments two years later. After the employee had earned the amount for the second year, and the amount had been calculated at $87,076, the employee and the employer agreed to make a subsequent deferral of that $87,076 amount, so that instead of the amount being paid in quarterly installments all in the fourth year, the amount would be paid in five annual installments. *Id.* at 920. The IRS challenged the subsequent deferral, arguing that the employee should be taxed on the amount in the fourth year when the amount was originally scheduled to be paid. The Tax Court concluded that the employee should not be taxed on the amount until he actually receives the cash payment. The Tax Court held that the parties can defer the payment at any time before the amount is payable. *Id.* at 922. In a later case, the Tax Court held that subsequent deferrals would be respected even if an employer routinely consented to its employees’ requests to extend the payment dates. *Metcalfe v. Commissioner*, 43 T.C.M. (CCH) 1393 (1982).

The ABA argued that the existence of this right should not trigger an income tax liability for the employee. American Bar Association Section of Taxation, Committee on Employee Benefits, *supra* note 93, at 235-36 (1996). The ABA Committee’s Report was in response to a request for comments on IRS Revenue Procedure 92-65, 1992-2 C.B. 428.

---

138 Specifically, in *Veit v. Commissioner*, 8 T.C.M. (CCH) 919 (1949), the employee and employer entered into an agreement in which the employee would receive 10% of the corporation’s profits for two years as compensation, and the amount for the second year would be paid in four quarterly installments two years later. After the employee had earned the amount for the second year, and the amount had been calculated at $87,076, the employee and the employer agreed to make a subsequent deferral of that $87,076 amount, so that instead of the amount being paid in quarterly installments all in the fourth year, the amount would be paid in five annual installments. *Id.* at 920. The IRS challenged the subsequent deferral, arguing that the employee should be taxed on the amount in the fourth year when the amount was originally scheduled to be paid. The Tax Court concluded that the employee should not be taxed on the amount until he actually receives the cash payment. The Tax Court held that the parties can defer the payment at any time before the amount is payable. *Id.* at 922. In a later case, the Tax Court held that subsequent deferrals would be respected even if an employer routinely consented to its employees’ requests to extend the payment dates. *Metcalfe v. Commissioner*, 43 T.C.M. (CCH) 1393 (1982).

139 The ABA argued that the existence of this right should not trigger an income tax liability for the employee. American Bar Association Section of Taxation, Committee on Employee Benefits, *supra* note 93, at 235-36 (1996). The ABA Committee’s Report was in response to a request for comments on IRS Revenue Procedure 92-65, 1992-2 C.B. 428.

140 *IRC § 409A(a)(4)(C)(iii).*
141 *Id. § 409A(a)(4)(C)(i).*
142 *Id. § 409A(a)(4)(C)(ii).*
emergency) before the expiration of the 5-year period.\(^\text{143}\) In applying the requirement that a payment must be deferred for at least an additional 5 years, the regulations create some important rules regarding a “payment.”

<table>
<thead>
<tr>
<th>General Rule Regarding a “Payment”</th>
<th>Generally, a payment is a “separately identifiable amount [that an employee is entitled to receive] under a plan on a determinable date . . . . [A]n amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula.”(^\text{144})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments in the Form of a Life Annuity</td>
<td>“The entitlement to a life annuity is treated as the entitlement to a single payment.”(^\text{145}) This rule can greatly restrict flexibility. “[A]n election to delay payment of a life annuity . . . must be made at least 12 months before the scheduled commencement of the life annuity, and must defer the payment for a period of not less than five years from the originally scheduled commencement of the life annuity.”(^\text{146})</td>
</tr>
<tr>
<td>Installment Payments that Are Not in the Form of an Annuity</td>
<td>“A series of installment payments is treated as a single payment unless the plan provides at all times . . . that the right to the series of installment payments is to be treated as a right to a series of separate payments.”(^\text{147}) For prior plans, this designation can be made in writing on or before December 31, 2008.(^\text{148})</td>
</tr>
</tbody>
</table>

The failure to amend an NQDC plan document to provide that installment payments are treated as separate payments will greatly restrict flexibility (and will be a trap for the unwary).

**EXAMPLE #11.** Amanda elects to defer amounts under an NQDC plan which provides that she will receive annual installment payments beginning when she turns 65. Each installment payment will be equal to her NQDC account balance multiplied by a fraction equal to 1 divided by

\(^{144}\) Id. § 1.409A-2(b)(2)(i).
\(^{145}\) Id. § 1.409A-2(b)(2)(ii).
\(^{146}\) Id. § 1.409A-2(b)(2)(ii)(A).
\(^{147}\) Id. § 1.409A-2(b)(2)(iii).
\(^{148}\) Id. See IRS Notice 2007-86, § 3.01A, 2007-46 I.R.B. 990 (Oct. 22, 2007) (“During 2008, Taxpayers are not required to comply with the requirements of the final regulations . . . .”).
the number of years until she attains age 75 (in other words, at age 65 she will receive $1/10^{th}$ of the account balance; at age 66 she will receive $1/9^{th}$ of the account balance, etc.)

Amanda is 61 and realizes she will not need any payments until she attains age 70. If the NQDC plan document fails to include the magic language that each installment will be treated as a separate payment, she has no flexibility. In that case, to avoid a 409A Plan Failure, Amanda must begin receiving the ten payments annually beginning when she turns 65. However, if the plan document states that each installment is a separate payment, although she must receive the scheduled payments when she is 65 and 66, she can elect to defer the amounts that otherwise would be paid when she is 67, 68, 69, or older, as long as that is permitted under the language of the plan document.

The final regulations for the subsequent deferral rule include several other specific rules:

<table>
<thead>
<tr>
<th>Beneficiary</th>
<th>Although the final regulations on this point are abstruse, the preamble to the final regulations is clear that a 409A Plan Failure occurs if an NQDC plan provides that after the death of an employee, the designated beneficiary can elect a new time and form of payment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Divorce – QDRO</td>
<td>Any subsequent deferral “reflected in, or made in accordance with, the terms of a domestic relations order” will not violate the 1 year/1 year/5 year rule.</td>
</tr>
<tr>
<td>Coordination with Prohibition on Accelerating</td>
<td>As long as an election complies with the 1 year/1 year/5 year rule, it will not violate the 409A prohibition on accelerations. This can be helpful if the NQDC benefits are payable in the form of a life income.</td>
</tr>
</tbody>
</table>

---

149 See Treas. Reg. § 1.409A-2(b)(3) (2007) (“The rules of [Treas. Reg. § 1.409A-2(b) (2007)] governing changes in the time and form of payment apply to elections by beneficiaries with respect to the time and form of payment, as well as elections by [employees] or [companies] with respect to the time and form of payment to beneficiaries.”).

150 The preamble states: Commentators requested that beneficiaries be permitted a limited period of time in which to change the time and form of payment without being subject to the subsequent deferral and anti-acceleration provisions. The Treasury Department and the IRS do not believe that the statutory language supports this type of late deferral election or payment acceleration. Accordingly, these suggestions are not adopted in the final regulations. 72 Fed. Reg. at 19264. However, a change in the identity of the beneficiary will not be treated as a subsequent election. Treas. Reg. § 1.409A-2(b)(3) (2007). Thus, the employee can always change his or her designated beneficiary, and presumably a designated beneficiary (who is an individual) should be able to change his or her selection of subsequent beneficiaries.


152 The prohibition on accelerations is discussed at Part IV infra.
Payments annuity, or if the NQDC benefits are payable in installments when
the plan document fails to state that each installment is a separate
payment.\textsuperscript{153} For example, if an employee is scheduled to begin
receiving 10 annual installment payments on January 1, 2010, and
the installments are treated as a single payment for these purposes,
the employee could elect (before December 31, 2008) to receive a
lump sum at any time on or after January 1, 2015.\textsuperscript{154} Although
such an election effectively accelerates the payments that otherwise
would have been due in 2016 through 2019, this election would not
violate the no-acceleration rule of IRC § 409A(a)(3). An example
illustrates this same opportunity when NQDC benefits are payable
as a life annuity.\textsuperscript{155}

| 162(m) - A Special Benefit for Publicly-Traded Corporations and Their Top Executives Earning Over $1 Million Annually |
|---|---|
| IRC § 162(m) basically prohibits a publicly traded corporation from claiming an income tax deduction for fixed compensation in excess of $1 million per year paid to its president or any of its four highest-ranking officers (other than the president).\textsuperscript{156} A corporation and any of these highly-paid executives can agree to delay an NQDC payment, without regard to the 1 year/1 year/5 year rule, if (i) the corporation “reasonably anticipates that if the payment were made as scheduled, the [corporation’s income tax] deduction … would not be permitted due to the application of [IRC] § 162(m);” (ii) the payment will be made in the next taxable year in which the corporation “reasonably anticipates, or should reasonably anticipate” that its deduction will not be barred by IRC § 162(m);\textsuperscript{157} and (iii) “the [corporation] treats all payments to similarly situated [executives] on a reasonably consistent basis.”\textsuperscript{158} This option to further defer may be a significant benefit for a highly-paid executive because it will allow those amounts to continue to grow tax-free.\textsuperscript{159} |

IV. THE NO-ACCELERATION RULE AND ITS 13 EXCEPTIONS

“The problem with practicing tax law is that the general rule never seems to apply to anything.”\textsuperscript{160}

\textsuperscript{153} Id. § 1.409A-2(b)(2)(iii).
\textsuperscript{154} Id. § 1.409A-2(b)(5).
\textsuperscript{155} Id. § 1.409A-2(b)(9) (Ex. 17).
\textsuperscript{156} IRC § 162(m). A major loophole is that “performance-based compensation,” including stock options, is not subject to the $1 million cap. Id. § 162(m)(4)(C).
\textsuperscript{157} Treas. Reg. § 1.409A-2(b)(7)(i) (2007). The other 409A rule applicable only to publicly traded corporations is that when certain top executives separate from service, they cannot receive payments for six months. IRC § 409A(a)(2)(B)(i).
\textsuperscript{159} Drew & Johnston, supra note 30, at A15.
\textsuperscript{160} Yablon, supra note 1, at 160 (quoting an anonymous tax lawyer).
“Contrary to what some people claim, the tax laws have a lot of respect for logic. They use it so sparingly.”

“The tax code has just grown so complex and so ugly, like an unkempt hedge or lawn that never gets mowed.”

The Joint Tax Committee asserted that employees and companies had too much “control” over the timing of NQDC benefit payments, and Congress agreed. As a result, Congress enacted an acceleration prohibition in IRC § 409A(a)(3). If either the employee or the company causes NQDC to be paid before the scheduled payment date, a 409A Plan Failure occurs.

Congress granted the IRS authority to create exceptions, and the IRS created 13 exceptions. An NQDC plan document may require that the company accelerate the payment in these 13 situations, or the plan document may provide that the company has discretion. Except as otherwise required by the language of the particular exception, “the plan need not set forth the exception[s] in writing.” A summary of the 13 exceptions follows.

| 1. Exception if Divorce Requires Acceleration | If a qualified domestic relations order (“QDRO”) requires that NQDC payments be made to an individual other than the employee (i.e., an ex-spouse), then an |

---

161 Id. at 118 (quoting Jeffrey L. Yablon).
162 Id. at 117 (quoting Alan Blinder).
163 Enron Compensation Report, supra note 17, at 634-5; id. at 20.
164 H.R. Rep. No. 108-548, pt.1, reprinted in [2007] 7 Stand. Fed. Tax Rptr. (CCH) ¶ 18,952, at page 36,143 (“The Committee believes that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion.”).
165 IRC § 409A(a)(3) (The no-acceleration rule will be satisfied “if the plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided in regulations [issued] by the Secretary [of the Treasury].”).
166 Treas. Reg. § 1.409A-3(j)(4)(i) (2007). The employee cannot be given discretion to accelerate payments even upon the occurrence of one of the thirteen exceptions. Id.
167 Id.
acceleration can be made “to the extent necessary to fulfill [the] domestic relations order.”  

2. The Dick Cheney Exception

If a federal officer or employee in the executive branch enters into an ethics agreement with the federal government requiring an accelerated payment of her NQDC, the amount specified can be paid without triggering a 409A Plan Failure. Also, the payment of an amount can be accelerated if the payment is “reasonably necessary to avoid the violation of an applicable federal, state, local or foreign ethics law or conflicts of interest law -- [even if] other actions would result in compliance with the . . . [law].”

3. Exception if the Account Balance Is $15,500 or Less (Indexed for Inflation)

The company can pay the employee an amount equal to his or her entire interest in the plan if the amount is below the “applicable dollar amount under [IRC § 402(g)(1)(B), which is $15,500 for 2008].”

4. Exception for Plan Terminations and Liquidations

Three situations permit an acceleration. First, if the company terminates and liquidates the plan within 12 months of a corporate dissolution taxed under IRC § 1.409A-3(j)(4)(ii)(A).

---

168 Id. § 1.409A-3(j)(4)(ii).
169 Before becoming Vice President, Dick Cheney worked for Halliburton. Complaints were made that Vice President Dick Cheney’s right to receive NQDC payments from Halliburton was a conflict of interest. After he claimed to have severed all interests in Halliburton, Vice President Cheney received $2 million in bonuses and NQDC from Halliburton. CNN Live Today: People Along Gulf Beginning Cleanup in Wake of Ivan; Kerry Speaks in New Mexico, Emmys on Sunday Night (CNN television broadcast, Sept. 17, 2004) (“T[he Independent Congressional Research Service found that under federal ethics laws, Dick Cheney did have a lingering financial interest in Halliburton.”).
171 Id. § 1.409A-3(j)(4)(ii)(B).
172 Id. § 1.409A-3(j)(4)(v). The limit for 2007 and 2008 is $15,500. See IRS Releases Retirement Plan Limits for 2007; Taxation for Accountants (WG&L Dec. 2006) (“The [IRC § 402(g)(1)] limit on the exclusion for elective deferrals described in [IRC §] 402(g)(3) increases from $15,000 to $15,500.”), available at http://checkpoint.riag.com/app/servlet/com.tta.checkpoint.servlet.CPDocTextServlet?used=The maximum amount previously was $10,000, 72 Fed. Reg. at 19268, but the reference to IRC § 402(g)(1)(B) was added to increase the amount, and to allow the amount to increase for inflation over time. 72 Fed. Reg. at 19268 (April 7, 2007).
331 (or with the approval of a Bankruptcy Court under 11 U.S.C. § 503(b)(1)(A)) the company can accelerate the payments.\textsuperscript{173} Second, if there is a “change in control” event (as described in Treas. Reg. § 1.409A-3(i)(5) (2007)) and all similar NQDC plans are “terminated and liquidated with respect to each participant,” the amounts can be paid “pursuant to irrevocable action . . . within 30 days preceding, or the 12 months following [the change in control] event.”\textsuperscript{174} Third, a plan can be terminated, and all amounts can be paid out, if various requirements are satisfied, including (i) there has not been a “proximate . . . downturn in the financial health of the [company];” (ii) the company liquidates all similar NQDC arrangements; (iii) “no payments in liquidation . . . are made within 12 months of the date the [company] takes all necessary action to irrevocably terminate and liquidate the plan;” (iv) “all payments are made within 24 months of the date” of the action to terminate; and (v) the company does not adopt a new plan within 3 years.\textsuperscript{175}

<table>
<thead>
<tr>
<th>5. Exception for Paying Taxes Required by IRC § 457(f)</th>
<th>Tax-exempt employers must include a \textit{substantial risk of forfeiture}\textsuperscript{176} in NQDC plans described in IRC § 457(f). If the \textit{substantial risk of forfeiture} lapses, the employee will be taxed on the NQDC immediately even if no cash or property is paid to the employee.\textsuperscript{177} The 409A regulations allow an accelerated distribution equal to the “federal, state, local and foreign income tax withholding that would [be] remitted by the employer” on the amount included in income.\textsuperscript{178}</th>
</tr>
</thead>
</table>

\textsuperscript{174} \textit{Id.} § 1.409A-3(j)(4)(ix)(B).
\textsuperscript{175} \textit{Id.} § 1.409A-3(j)(4)(ix)(C).
\textsuperscript{176} See IRC § 457(f). For a general discussion of these types of plans, see Goldstein, Swirnoff & Drennan, \textit{supra} note 40, at 188-94.
\textsuperscript{177} IRC § 457(f)(1)(A).
<table>
<thead>
<tr>
<th>7. Exception for a Payment Up to the Amount of Income Included Under 409A</th>
<th>The employer can accelerate a payment in the case of a 409A Plan Failure. This provision is unusual for at least two reasons. First, Congress went to great extremes to penalize the employee for a 409A Plan Failure, but this opportunity to accelerate provides a safe way to reduce the practical sting for the employee. Second, the amount that can be accelerated is not tied to the employee’s actual tax liability from the 409A Plan Failure. Instead, the regulation allows an accelerated payment up to “the amount required to be included in income as a result of the [409A Plan] Failure.” The employee’s actual increased income tax liability as a result of the 409A Plan Failure may be less than the amount required to be included in income.</th>
</tr>
</thead>
<tbody>
<tr>
<td>8. Exception for Payment of State, Local Taxes</td>
<td>The employer can make an accelerated payment to cover the withholding, FICA taxes, or unemployment taxes must be paid on NQDC that has not been paid to the employee yet, the employer can accelerate payments to cover these amounts. Although not entirely clear, the regulation also indicates that the employer can accelerate payments to cover the “pyramiding” of wages and taxes. This rule can help because the accelerated NQDC payment to cover the withholding tax liability will trigger additional tax liability, which will create a need to accelerate the payment of additional NQDC, which will trigger additional tax liability, and so on, and so on.</td>
</tr>
</tbody>
</table>

---

179 Id. § 1.409-3(j)(4)(vi).  
180 Id.  
181 This pyramiding problem occurs whenever extra taxable payments are made in an attempt to reimburse the recipient for the income taxes the recipient must pay on the amounts received. See Joel S. Newman, Federal Income Taxation, 43-45 (3rd ed. 2005) (discussing Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929)).  
183 See supra Part II.B(2) (discussing the calculation of the Terrible Triple Tax imposed for a 409A Plan Failure).  
185 See supra Part II.B(2) (regarding the calculation of the Terrible Triple Tax).
| or Foreign Taxes | payment up to the amount of state, local or foreign tax the employee pays as a result of NQDC amounts that the company has not paid yet to the employee under the NQDC plan.  

9. Cancellation of Deferral Election Because of Disability | Although elections to defer generally cannot be revoked once the year begins, the employee can cancel the election by the later of the end of the [company’s] taxable year . . . or the 15th day of the third month following the date the [employee] incurs a disability.” Amazingly, the regulations adopt a completely different definition of “disability” for this purpose than in the case of determining whether distributions can be made upon disability. For purposes of this exception from the acceleration prohibition:  

[A] disability refers to any medically determinable physical or mental impairment resulting in the [employee’s] inability to perform the duties of his or her position or any substantially similar position, [if] such impairment can be expected to result in death or can be expected to last for a continuous period of not less than six month.  

10. Cancellation of Deferral Election Following an Unforeseeable Emergency or Hardship Distribution | “The deferral election must be cancelled, not merely postponed or otherwise delayed.”  

---

187 Id. § 1.409A-2(a)(1).  
188 Id. § 1.409A-3(j)(4)(xii).  
189 For purposes of allowing payments on disability, the employee generally must have already been receiving income replacement payments for 3 months under the company’s disability plan, or be incapable of engaging in any substantial gainful employment. IRC § 409A(a)(2)(C); Treas. Reg. § 1.409A-3(i)(4)(i) (2007). In providing that a “disability” is a “permissible payment” event, IRC § 409A(a)(2)(C); Treas. Reg. § 1.409A-3(i)(4)(i) (2007); see infra notes 230-33 and accompanying text, the statute and regulations create a much stricter definition of disability, basically requiring that (i) the employee cannot engage in any substantial gainful employment (without regard to his or her former job), or (ii) the employee has already been receiving disability payments for three months. Id.  
190 Id. § 1.409A-3(j)(4)(xii) (emphasis added).  
191 Id. § 1.409A-3(j)(4)(viii).
11. Offsets up to $5,000

The regulations only allow an offset if the employee’s debt to the company was “incurred in the ordinary course of the service relationship between the [employee] and the [company],” the amount of the debt is $5,000 or less, and the debt is payable.\(^\text{192}\)

12. Bona Fide Disputes as to the Employee’s Right to a Payment -- 25% “Haircut” Required and There Cannot Have Been a “Financial Health Downturn”

With this exception, the IRS attempts to balance two concerns. On the one hand, as with any contract, the parties may have legitimate disputes about the company’s liability (and the amount of the liability). For example, the employee may be entitled to payments only if fired without “cause,” and the parties may have very different views on why the employee was fired. On the other hand, if the parties can simply agree to an immediate payout of a reduced amount to satisfy the company’s NQDC obligation, the arrangement resembles Enron “10% haircut” provision.\(^\text{193}\) The final regulations strike a balance by establishing four rules:

- A payment will only qualify for this exception if it is a settlement of “an arm’s length, bona fide dispute as to the [employee’s] right to the deferred amount.”\(^\text{194}\)
- “A payment will be presumed not to meet this exception if the payment is made proximate to a downturn in the financial health of the [company].”\(^\text{195}\)
- There is a presumption that the payment does not meet this exception unless there is a “substantial reduction” in the amount that would have been paid in the absence of a dispute, and “a reduction that is less than 25 percent of the present value of the deferred amount in dispute.”

\(^\text{192}\) Id. § 1.409A-3(j)(4)(xiii).

\(^\text{193}\) See supra notes 78-79 and accompanying text.


\(^\text{195}\) Id. § 1.409A-3(j)(4)(xiv).
<table>
<thead>
<tr>
<th>13. Distribution to Avoid a “Nonallocation Year Under [IRC] [S]ection 409(p)”¹⁹⁸</th>
<th>A plan may qualify as an employee stock ownership plans (“ESOPs”) if certain payments can be accelerated. As an indication of the potential level of complexity that arises when 409A meets other tax rules, the 409A regulations state, “Solely for purposes of determining permissible distributions . . . synthetic equity . . . granted during the plan year of the [ESOP] in which such payment is made is disregarded for purposes of determining whether the subsequent plan year would result in a nonallocation year.”¹⁹⁹</th>
</tr>
</thead>
</table>

V. THE PERMISSIBLE PAYMENT RULES CAN ONLY BE SATISFIED BY THOSE WHO STUDY 409A

“I think there is something desperately wrong with the system when there is only a small subset of people who understand how it works.”²⁰⁰

“Complexity does not enter the tax code so much out of malevolence as through misguided reform efforts.”²⁰¹

“We have a tax code that favors those with the best accountants.”²⁰²

One of the most disturbing features of 409A is that an attorney, human resources professional, company representative, employee, or anyone else drafting an employment agreement (or any contract regarding an employment relationship) is bound to trigger a

---

¹⁹⁶ Id. (emphasis added).
¹⁹⁷ Id. (emphasis added).
¹⁹⁸ Id. § 1.409A-3(j)(4)(x).
¹⁹⁹ Id. (emphasis added).
²⁰⁰ Yablon, supra note 1, at 159 (quoting Todd McCracken).
²⁰¹ Id. at 116 (quoting Sheldon D. Pollack).
²⁰² Id. at 157 (quoting Shane Keats).
409A Plan Failure, and the resulting Terrible Triple Tax, if the agreement provides for payments more than 2 ½ months after the end of a year and the drafter does not have a copy of the 409A regulations handy.\textsuperscript{203} Although the legislative history states that Congress enacted 409A to prohibit employees from having “inappropriate levels of control or access to amounts deferred,”\textsuperscript{204} a drafter can easily trigger a 409A Plan Failure even when the employee has no “access or control.”

A 409A Plan Failure automatically occurs if an NQDC plan document provides for payments upon the occurrence of an event which is not one of the five permissible payment events allowed under 409A. The 409A Authorities precisely define the permissible payment events, and even a slight variation from the terms specified will trigger a 409A Plan Failure. Drafters will inadvertently trigger 409A Plan Failures because 409A demands that the drafter use magic verbiage to describe the “permissible payment events,”\textsuperscript{205} as demonstrated by the following examples.

\textbf{EXAMPLE #12}. Samantha Sports-Agent drafts an employment agreement between her client, Sabrina Speed, and the San Diego Shuffle, a professional soccer team. Sabrina knows it is highly unlikely that her professional sports career will last for 10 years or more. As a result, Sabrina wants a portion of her compensation paid over 5 years beginning in 10 years. However, if she becomes disabled, the deferred payments should begin immediately. When asked, Sabrina says that disability for her means no longer being able to play professional soccer due to a physical or mental injury or illness. Sports-Agent drafts the employment agreement following Sabrina’s desires regarding payments upon disability. This will trigger a 409A Plan Failure because Sabrina could receive amounts other than upon the occurrence of a permissible payment event. Specifically, under IRC § 409A(a)(2)(C), payments can only be made upon disability if “disability” is defined as (i) being unable to engage in any substantial gainful activity, or (ii) “receiving income replacement

\textsuperscript{203} Payments made within 2 ½ months of the end of the tax year generally are exempt from 409A under the “short-term deferral” rule. Treas. Reg. § 1.409A-1(b)(4) (2007).


benefits for a period of not less than 3 months under a [disability] plan . . .
.” Because Sports-Agent failed to include the magic 3-month verbiage of IRC § 409A(a)(2)(C)(ii), Sabrina will be subject to the Terrible Triple Tax. The Terrible Triple Tax will apply even if no payments are ever made to Sabrina under the disability clause in the employment contract.

EXAMPLE #13. Same as Example #12 except that instead of the disability provision, Sabrina requests that payments begin if she “terminates employment” with the San Diego Shuffle. Although IRC § 409A(a)(2)(A)(i) allows payments on a “separation from service,” payments are not permitted under 409A if (i) the individual terminates employment but continues to work for the company as an independent contractor in certain circumstances;\(^\text{206}\) or (ii) the individual terminates employment with the company, but is employed by an affiliated entity.\(^\text{207}\) Sports-Agent follows Sabrina’s directions in drafting the employment agreement. Because the San Diego Shuffle could make payments in those two situations, Sabrina’s employment agreement would allow NQDC payments other than upon the occurrence of a permitted payment trigger. As a result, Sports-Agent’s document would immediately trigger a 409A Plan Failure.\(^\text{208}\)

EXAMPLE #14. Same as Example #12 or Example #13, but instead of payments beginning on disability or termination of employment, Sabrina desires that payments will begin if the ownership of the San Diego Shuffle changes. However, Sports-Agent’s description of an ownership change in the employment agreement does not match the definition\(^\text{209}\) of “a change in the ownership or effective control” under 409A,\(^\text{210}\) and would allow payments earlier than allowed under 409A. As a result, Sports-Agent’s draft would immediately trigger a 409A Plan Failure.

The final regulations express the demanding nature of this “permissible payment” requirement by using the word “only” twice. “The [permissible payment] requirement[s] are met only if the plan provides that [NQDC] may be paid only upon an event or time set forth in [Treas. Reg. § 1.409A-3(a)].”\(^\text{211}\) Thus, language in an NQDC document that a company will make a payment sooner than upon (i) the dates specified at the time of


\(^{207}\) \textit{Id.} § 1.409A-1(h)(3).

\(^{208}\) The plan would allow payments to be made other than as permitted by IRC § 409A(a)(2).

\(^{209}\) IRC § 409A(a)(2).


\(^{211}\) \textit{Id.} § 1.409A-3(a) (emphasis added).
deferral, or (ii) the occurrence of a 409A permissible payment event, will constitute a 409A Plan Failure. This will trigger the Terrible Triple Tax, even if such event never occurs and the company never makes a payment under the non-conforming language.

A. Payments at a Fixed Time or Under a Fixed Schedule.

409A permits payments at a fixed time, or under a fixed schedule, established before or at the time of the deferral.\textsuperscript{212} The NQDC plan document can provide for payments under an “objective, non-discriminating formula.”\textsuperscript{213} For example, the document can provide that the NQDC benefit payments will be reduced by the amount of Social Security or disability pay received by the employee.\textsuperscript{214}

B. General Comments on Payments Upon the Occurrence of 1 of the 5 “Permissible Payment” Events.

In addition to allowing payments at a fixed time or under a fixed schedule established at the time of the deferral, IRC § 409A(a)(2)(A) permits payments upon the occurrence of one, a few, or all, of the following five events:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>#1</td>
<td>Death</td>
</tr>
<tr>
<td>#2</td>
<td>Disability</td>
</tr>
<tr>
<td>#3</td>
<td>Separation from service</td>
</tr>
<tr>
<td>#4</td>
<td>The occurrence of an unforeseeable emergency</td>
</tr>
<tr>
<td>#5</td>
<td>“[A] change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation”\textsuperscript{215}</td>
</tr>
</tbody>
</table>

\textsuperscript{212} IRC § 409A(a)(2).
\textsuperscript{214} Id.
\textsuperscript{215} IRC § 409A(a)(2)(A).
Drafters customarily combine multiple payment events. For example, an NQDC plan could provide that payments will begin upon the first to occur of: (i) the employee attaining age 65; (ii) the employee’s death; (iii) the employee’s disability; (iv) the employee’s separation from service; or (v) the occurrence of a change of ownership or control.\footnote{See Goldstein, Swirnoff & Drennan, \textit{supra} note 40, at 58 (listing many triggering events).} The final regulations confirm that a drafter can include multiple payment events in one NQDC plan.\footnote{Treas. Reg. § 1.409A-3(b) (2007) (“A plan may provide for payment upon the earliest or latest of more than one event or time, provided that each event or time is described in [Treas. Reg. § 1.409A-3(a)(1)-(6) (2007)].”).}

When the occurrence of a “permissible payment event”\footnote{The term “permissible payment event” is used by the IRS in the Treasury Regulations. See Treas. Reg. § 1.409A-3(b) (2007).} triggers a right to a payment, the company must make the payment (i) within 90 days;\footnote{\textit{Id.} § 1.409A-3(b).} (ii) within 2½ months after the end of the tax year;\footnote{Id. § 1.409A-3(d).} or (iii) on the date the event occurs “or a later date within the [employee’s] taxable year.”\footnote{Id. § 1.409A-3(d).} Also, the plan can permit payment up to “30 days before the designated payment date.”\footnote{Id. (emphasis added).} An example in the regulations demonstrates a trap for the unwary.

[The NQDC plan provides] for a lump sum payment on or before the 180\textsuperscript{th} day [after the employee] separates from service. [The company] retains the sole discretion to determine when during the 180-day period the payment will be made. Because the plan does not specify a period during one calendar year in which the payment will be made, and because the period over which the payment may be made is longer than 90 days, the [provision creates a 409A Plan Failure].\footnote{Id. § 1.409A-3(i)(1)(vi)(Example #3).}

If the company fails to make an NQDC payment when scheduled, either intentionally or unintentionally, that will disrupt the timing of payments which triggers a
409A Plan Failure unless an exception applies. There are two exceptions. First, there will be no 409A Plan Failure if the company delays payment because making the payment would jeopardize the company’s existence as a going concern. Second, the company’s failure to make a payment on time will not be a 409A Plan Failure if the following five conditions are satisfied:

1. The employee does not give his or her “express or implied consent” to the delay.
2. The employee accepts any past payment the company is willing to make.
3. The employee makes “prompt and reasonable good faith efforts to collect the . . . payment [due].” “[E]fforts to collect will be presumed not to [meet this test] unless the [employee] provides notice to the [company] within 90 days . . . and . . . takes further enforcement measures within 180 day . . . .”
4. “[A]ny further payment . . . is made no later than the end of the first taxable year of the [company] in which the [company] and the [employee settle, or a judgment or other] binding decision is reached.
5. The company’s decision to fail to make the payment when due was “not made by the employee, any member of the employee’s family, any person over whom the employee or the employee’s family has “effective control,” or any person any portion of whose compensation is controlled [by] the [employee] or the [employee’s] family . . . .”

If the parties satisfy all five of these conditions, the IRS will not treat the company’s delay in making the payment as a 409A Plan Failure.

C. The Five Permissible Payment Events.

1. Death. Neither the statute nor the regulations attempt to provide a specific definition of “death” for 409A purposes.
2. **Disability.** The IRS regulations provide multiple definitions of the term *disability*. On the one hand, an employee can cancel a deferral election upon becoming disabled, and in that situation, an employee can be disabled when he or she will not be able to perform *his or her own job* or a substantially similar job, for at least six months because of a physical or mental impairment.\(^{230}\)

**EXAMPLE #15.** The CEO of the company suffers a stroke. Although there are many jobs at the company the CEO would be qualified to fill, she cannot continue as CEO or any substantially similar position. Under 409A, her elective deferrals could automatically terminate.

On the other hand, 409A provides that an employee’s *disability* is a “permissible payment event,”\(^{231}\) and for that purpose the definition of *disability* is much stricter. Basically, an employee must be (i) incapable of engaging in “any substantial gainful activity” or (ii) must have been receiving income replacement payments for at least three months under the company’s disability plan.\(^{232}\) Thus, the CEO described in Example #22 could not begin receiving NQDC payments because of the disability.\(^{233}\) If an advisor inadvertently uses the wrong IRS definition of “disability” in an NQDC plan document, all the employees participating in the plan must pay the Terrible Triple Tax.

---

230 See supra notes 188-90 and accompanying text. Treas. Reg. § 1.409A-3(j)(4)(xii) (2007) provides: For purposes of this paragraph, a disability refers to any medically determinable physical or mental impairment resulting in the [employee’s] inability to perform the duties of *his or her position* or any substantially similar position, where such impairment can be expected to result in death or can be expected to last for a continuous period of not less than six months. (emphasis added)


233 Under 409A, if the NQDC plan allowed the company to begin making NQDC payments before the company’s disability plan paid income replacement payments for at least three months, the existence of the provision in the NQDC plan document would trigger a 409A Plan Failure.
EXAMPLE #16. Gary Generalist is an attorney conducting a general practice and is not a 409A specialist. Gary prepares a salary continuation plan providing that payments will begin to be made under the salary continuation plan on the first to occur of the employee’s disability, death, separation from service or a change of control. In defining “disability” for purposes of when payments begin, Gary uses the definition in Treas. Reg. § 1.409A-3(j)(5)(xii), instead of the definition in Treas. Reg. §1.409A-3(i)(4)(i). This drafting mistake is a 409A Plan Failure, and all of the employees participating in the NQDC plan must pay the Terrible Triple Tax.

3. Unforeseeable Financial Emergency. As under pre-409A law, a company can make NQDC payments upon the occurrence of an unforeseeable financial emergency, but the amount the company can distribute “must be limited to the amount reasonably necessary to satisfy the emergency need.” “Whether [an employee] is faced with an unforeseeable emergency . . . is . . . determined . . . on . . . the . . . facts and circumstances of each case.” The regulations provide examples of five situations that may constitute an unforeseeable emergency, and two situations that generally will not.

<table>
<thead>
<tr>
<th>Possible Unforeseeable Financial Emergencies</th>
<th>Generally NOT an Unforeseeable Financial Emergency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illness of employee or the employee’s spouse, beneficiary or dependent.</td>
<td>The payment of college tuition</td>
</tr>
<tr>
<td>Loss of employee’s property due to casualty (not covered by insurance).</td>
<td>The purchase of a home</td>
</tr>
<tr>
<td>“Imminent foreclosure of, or eviction from, the employee’s primary residence.”</td>
<td></td>
</tr>
<tr>
<td>Need to pay for medical expenses.</td>
<td></td>
</tr>
</tbody>
</table>

---

235 Treas. Reg. § 1.409A-3(i)(3)(ii) (2007). The company can also distribute an amount that is necessary to pay the taxes on the distribution. Id.
236 Id. § 1.409A-3(i)(3)(i).
Need to pay funeral expenses of a spouse, beneficiary or dependent.\textsuperscript{237}

“[A] distribution on account of [an] unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the [employee’s] assets . . . or by cessation of deferrals under the [NQDC] plan.”\textsuperscript{238}

4. \textbf{Separation from Service}. The “separation from service”\textsuperscript{239} trigger is extremely important. Almost all NQDC arrangements will provide for a lump sum payment, or the beginning of installment payments, when an employee’s employment terminates, whether because the employee retires, quits, is fired (with or without cause), or terminates for any other reason. If the employee retires or otherwise does not expect to return to work, the employee may need the money.\textsuperscript{240} Even if the employee will keep working elsewhere, the employee likely will prefer to receive payments promptly for fear that her former company may try to renege on its NQDC obligations or that its cash flow position or financial strength may deteriorate.\textsuperscript{241}

\textsuperscript{237} \textit{Id.}
\textsuperscript{238} \textit{Id.}
\textsuperscript{239} IRC § 409A(a)(2)(A)(i).
\textsuperscript{240} One study reported:
Eight out of ten senior executives at midsize companies (revenues of $1 billion to $2.5 billion) can expect annual retirement incomes – from social security and qualified plans – that are less than a third of their final-year compensation. Half the 250 executives studied will retire on less than 18% of their final year salary. Only 5% will receive 50% or more. By contrast, most people earning $50,000 or less can expect to nearly match their final-year pay.
\textsuperscript{241} Employees can have additional comfort if the company establishes a rabbi trust with an independent party (such as a bank or trust company) as trustee, and the company contributes sufficient assets to fund the rabbi trust. \textit{See} Rev. Proc. 92-64, 1992-2 C.B. 422 (the IRS provides a model rabbi trust form); Goldstein, Swirnoff & Drennan, \textit{supra} note 40, at 149-54.
The opening sentence on this topic in the regulations is wonderfully straightforward. “An employee separates from service with the employer if the employee dies, retires, or otherwise has a termination of employment with the employer.”

However, substantial complexity lurks just beneath the surface. The regulations do not attempt to define “death” or “retirement” but deal with the following five difficult issues concerning “termination of employment:"

1. How long can an employee be on leave before there is a termination of employment?

2. How long can an employee be on disability leave before there is a termination of employment?

3. Has there been a separation from service if the employee technically terminates employment, but returns as an independent contractor? What if the employee switches from full-time to part-time (for example, from five-days-a-week to one-day-a-week)?

4. Has there been a separation from service if the employee terminates employment, but goes to work for a parent corporation, a subsidiary corporation, or another affiliated entity?

5. Has there been a separation from service if the company sells all its assets and terminates the employee, but the employee is hired by the purchasing corporation and continues to do the same job, at the same desk, as before the sale of assets?

The following summarizes the regulatory approach to these five topics.

| 1. Non-Disability Leave: The 6 Month Rule | There is no termination of employment if the employee is “on military leave, sick leave, or other bona fide leave of absence if the period of such leave does not exceed 6 months, or if longer, so long as the individual retains a right to reemployment . . . under an applicable statute or by contract.”

---

243 Id. § 1.409-1(h)(1)(i). “[I]f a tenured professor takes a leave of absence, but the professor retains a right to reemployment with the university as part of the professor’s tenured status, the professor will not be deemed to have terminated from employment merely due to the leave of absence from the university.” 72 Fed. Reg. at 19260 (preamble to the final regulations).
must be in writing. A leave of absence is bona fide "only if there is a reasonable expectation that the employee will return to [work]."  

| 2. Disability Leave: The 29 Month Rule | If the leave of absence is due to illness or injury the same rules as for other leave applies except that "29 months" is substituted for "6 months." The 29-month rule applies when the leave is "due to any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than six months, [and] . . . the employee [is] unable to perform the duties of his or her position of employment or any substantially similar position of employment . . . ." |

| 3. Switching from Full-Time to Part-Time: The 20% and 50% Presumptions, and the Chance to Pick Something in the Middle | The general rule focuses on the reasonable anticipations of the parties. A separation from service occurs if the employee and the company "reasonably anticipated that [(i)] no further services [will] be performed after a certain date, or [(ii)] that the level of bona fide services . . . [will] permanently decrease to no more than 20 percent of the average level of bona fide services performed . . . over the immediately preceding 36 month period . . . ." Under the regulations, it is irrelevant whether the employee continues working as an employee or as an independent contractor. In either situation, the regulations compare the level of service before and after the alleged separation from service. The regulations list three factors to consider, although other facts and circumstances may also be considered. Although the general test focuses on the parties' anticipations, the regulation goes on to create presumptions based on the level of work the individual actually performs. If the "level of bona fide services" drops to 20% or less of the average level of services for the preceding 36 months, the presumption is that the employee has separated from service. If the level |

---

245 Id.
246 Id. In contrast to the definition of "disability" under the "permissible payment" rules, see IRC § 409A(a)(2)(C), this rule focuses on the employee’s ability to perform his or her particular job, or a substantially similar job, rather than on whether the employee can engage in any substantial gainful activity.
248 Id.
249 Id. ("whether as an employee or as an independent contractor").
250 The regulations list the following three factors: "[(i)] whether the employee continues to be treated as an employee for other purposes (such as participation in . . . participation in employee benefit programs); [(ii)] whether similarly situated [employees] have been treated consistently; and [(iii)] whether the employee is permitted, and realistically available, to perform services for other [employers] in the same line of business." Id. The third factor is peculiar because the parties frequently sign a noncompete agreement in connection with a bona fide termination of employment.
251 Id.
of service is 50% or more, the presumption is that the employee has not separated from service. The regulations provide that the parties can specify in the written NQDC document that some reduced level of service between 20% and 50% (as compared to the level of service in the prior 12 months) will be a separation from service. In applying these presumptions, although the regulations specify 36-months or 12-months as the testing period before the alleged separation from service, the regulations are silent on the length of the testing period after the alleged separation from service – should it be one month? six months? one year? three years? Or should it depend on the facts and circumstances?

<table>
<thead>
<tr>
<th>4 What if the Employee Terminates Employment, But Goes to Work for a Parent, Subsidiary or Other Affiliated Entity?</th>
<th>Under the regulations, there is no “separation from service” if the former employer and the new employer are members of the same corporate group under IRC § 414(b) (which incorporates the controlled group tests of IRC § 1563(a)(1)-(3)), except that the tests are adjusted to make it more likely that the entities will be related.</th>
</tr>
</thead>
</table>
| 5 What if the Company Sells All of Its Assets and Terminates the Employee’s Employment, But the Employee is Hired by the Purchasing Company and Continues to Perform the Same Job at the Same Desk? The Parties Have Discretion. | The “seller and the buyer may retain the discretion to specify, and may specify, whether there has been a separation from service” in this situation if they satisfy three conditions:  
(i) The “asset purchase transaction results from bona fide, arm’s length negotiations;”  
(ii) All employees are “treated consistently” for these purposes; and  
(iii) The “treatment is specified in writing no later than the closing date of the asset purchase transaction.” |

252 Id. The parties can rebut these presumptions based on the facts and circumstances. For example, even if the employee’s intended replacement subsequently quits and the employee returns to work, there may still have been a separation from service. Id.

253 Id. The regulations do not explain why a 12-month test is used in applying a standard specified in a written NQDC document, but a 36-month test is used when applying the regulatory presumptions.

254 Id. § 1.409A-1(h)(3).

255 Id. For 409A purposes, the IRS changed the normal requirement that entities have “80% common ownership.” Under the IRS approach, the entities are affiliated for these purposes even if they have only “50% common ownership.”

256 Id. § 1.409A-1(h)(4).
5. **Change in Control.** Employees may become nervous about their NQDC benefits when:

- new people take control of the company -- will the new owners honor the company’s NQDC obligations?
- the company has a cash flow crunch -- will the owners place the NQDC obligations at the bottom of the bills to be paid?

One technique for addressing these concerns is the use of a rabbi trust. In addition, before 409A, the IRS ruled that a NQDC arrangement could provide that payments would begin upon a change of control without adverse income tax consequences.

IRC § 409A(a)(2)(A)(v) lists three types of “change in control events” that are permitted payment triggers under 409A:

(i) “a change in the ownership . . . of the corporation;”
(ii) “a change in the . . . effective control of the corporation;” or
(iii) “a change . . . in the ownership of a substantial portion of the assets of the corporation . . . .”

The regulations specify many requirements for analyzing whether a “change in control event” has occurred in various circumstances, but they can be summarized as a 50% test, a 40% test, and a 30% test.

<table>
<thead>
<tr>
<th>More Than 50% Test for Change in Ownership of a Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>“[A] change in the ownership of a corporation occurs on the date that any one</td>
</tr>
</tbody>
</table>

---

258 The IRS ruled that even if a NQDC plan provides that payments will begin upon a change of control, the employee will not be taxed on the accrued benefits until the amounts are actually paid. Priv. Ltr. Ruls. 92-04-012 (Oct. 23, 1991); 87-46-052 (Aug. 19, 1987). *See also* Goldstein, Swirnoff & Drennan, *supra* note 40, at 71 n.105.
259 The regulation provides that the term “change in control event” can refer to the three types of events collectively. Treas. Reg. § 1.409A-3(i)(5)(i) (2007).
260 See id. § 1.409A-3(i)(5). For example, when a company obligated to pay NQDC is part of a chain of corporations, the regulations discuss which entity must experience a “change in control event” in order for the employer to make a permitted payment under the NQDC plan. *See id.* § 1.409A-3(i)(5)(ii).
person, or more than one person acting as a group . . . acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of the stock of such corporation.”261 A stock redemption can trigger a “change in ownership” for these purposes.262

| 30% or More Test for Change in Effective Control of a Corporation | Even if a “change in ownership” (as described immediately above) does not occur, there could be a “change in effective control” if either of two situations occurs:

(i) If a person or group acquires during a 12-month period, “ownership of stock of the corporation possessing 30% or more of the total voting power of the stock of the corporation.”263

(ii) “[A] majority of members of the corporation’s board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation’s board of directors before the date of the appointment or election . . . .”264

40% or More Test for Asset Acquisitions

The company can make NQDC payments if an unrelated265 person or group acquires (within 12 months) company assets “that have a total gross fair market value equal to or more than 40% of the total gross fair

---

261 Id. § 1.409A-3(i)(5)(v)(A).
262 Id. § 1.409A-3(i)(5)(vi)(A)(1).
263 Id. § 1.409A-3(i)(5)(vi)(A)(2).
264 Id. § 1.409A-3(i)(5)(vi)(A)(2).
265 For related party rules, see Treas. Reg. § 1.409A-3(i)(5)(vii)(B).
market value of all of the [company’s] assets . . . ”

Although not addressed in the regulations, the preamble states that a “non-stock, nonprofit corporation may apply the change in effective control provisions . . . by analogy to changes in the composition of its board of directors, trustees, or other governing body.”

VI. OTHER COMPLEX 409A RULES

“All the Congress, all the accountants and the tax lawyers, all the judges, and a convention of wizards all cannot tell for sure what the income tax law says.”

“It was like listening to a tax lawyer read the lyrics to a love song.  All the words were there, nothing was inaccurate, but all the sizzle was gone.”

“I have something my doctor calls ‘narcotaxis.’  Within 20 seconds of hearing someone launch into an explanation of tax laws, my eyes become glassy, my body losses all feeling, and I go into a shallow coma.”

The 409A final regulations contain a myriad of other complex rules.  This part discusses three that will have significant practical importance.

A. Substantial Risks of Forfeiture

Historically, the employee would never need to pay income tax on deferred compensation as long as the amount was subject to a substantial risk of forfeiture.

When the company paid the benefit to the employee, the risk lapsed, and the employee

---

266 Id. § 1.409A-3(i)(5)(vii)(A).
267 72 Fed. Reg. at 19264.  A nonprofit corporation would apply the change in effective control provision in Treas. Reg. § 1.409A-3(i)(5) (which relates to a change in the composition of the board of directors).  This rule would apply to NQDC plans maintained by charities.
268 Yablon, supra note 1, at 109 (quoting Walter B. Wriston).
269 Id. at 157 (quoting Patricia Thomas).
270 Id. at 147 (quoting Russell Baker).
271 IRC § 83(a)(2).  See Goldstein, Swirnoff & Drennan, supra note 40, at 46.
would pay the tax at that time.\textsuperscript{272} Similarly, the constructive receipt doctrine treated a substantial risk of forfeiture as a substantial limitation or restriction preventing immediate taxation.\textsuperscript{273}

\textbf{EXAMPLE #17.} Under the NQDC plan, the company will begin making installment payments to Kathy when she attains age 65, unless she quits or is terminated for cause before attaining age 65. Under IRC § 83, the IRS ruled that this type of contingency creates a “substantial risk of forfeiture,”\textsuperscript{274} and Kathy need not pay income tax on the accrued NQDC benefit until the risk lapses.\textsuperscript{275}

Today, 409A changes the landscape of NQDC subject to a substantial risk of forfeiture. As a general rule, a 409A Plan Failure will not occur as long as an employee’s NQDC benefits are subject to a substantial risk of forfeiture.\textsuperscript{276} Also, the 409A statutory definition of a “substantial risk of forfeiture” is similar to the pre-409A definition of that phrase.\textsuperscript{277} However, IRC § 409A(e)(5) authorizes the IRS to issue regulations “disregarding a substantial risk forfeiture in cases where necessary to carry out the purposes of this section.”\textsuperscript{278}

The IRS regulations disregard a substantial risk of forfeiture in three key instances, potentially reversing the tax consequences in these situations. First, the

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{272} IRC § 83(a)(2).
\item \textsuperscript{273} See Treas. Reg. §1.451-2(a) (1957).
\item \textsuperscript{274} Priv. Ltr. Rul. 93-17-010 (Jan. 22, 1993).
\item \textsuperscript{275} In addition, Kathy must not have the ability to transfer the NQDC benefits. See IRC § 83(a). If Kathy works for a tax-exempt employer, the IRS will tax her on the entire accrued benefit when the risk of forfeiture lapses. See IRC § 457(f). If Kathy works for a taxpaying employer she likely will not be taxed on the NQDC until she actually receives the cash payments. See Goldstein, Swirnoff & Drennan, \textit{supra} note 40, at 60 (“Generally, a NQDC plan for a taxable employer will not be required to include a “substantial risk of forfeiture” to avoid taxation because a mere unfunded and unsecured promise to pay money in the future will not constitute “property” for purposes of [IRC] Section 83.”).
\item \textsuperscript{276} IRC § 409A(a)(1)(A).
\item \textsuperscript{277} \textit{Id.} § 409A(d)(4) provides that “[t]he rights of a person to compensation are subject to a substantial risk of forfeiture if such person’s rights to such compensation are conditioned upon the future performance of substantial services by any individual.” See also IRC § 457(f)(3)(B); IRC § 83(c). The 409A regulations state that the “occurrence of a condition related to a purpose of the compensation . . . (for example the attainment of a prescribed level of earnings or equity or completion of an initial public offering),” also can be a substantial risk of forfeiture under 409A. Treas. Reg. § 1.409A-1(d)(1) (2007).
\item \textsuperscript{278} IRC § 409A(e)(5) (emphasis added).
\end{enumerate}
\end{footnotesize}
IRS provides that benefits under an *elective* NQDC plan can never be subject to a substantial risk of forfeiture.\(^{279}\) This change would impact a substantial percentage of all NQDC arrangements.\(^{280}\) This regulation likely is an invalid exercise of IRS authority. The statute only allows the IRS to disregard a substantial risk of forfeiture if it is “necessary to carry out the purposes of [409A].”\(^{281}\) The legislative history discusses only one purpose for 409A -- to prevent employees from having “inappropriate levels of control or access to amounts deferred.”\(^{282}\) Merely allowing an employee to elect to defer compensation can not be an “inappropriate level of control or access.” IRC § 409A(a)(4) provides that employees can elect to defer compensation in compliance with 409A. This would not be the first time the IRS issued invalid regulations in an attempt to attack elective NQDC.\(^{283}\)

\(^{279}\) Treas. Reg. § 1.409A-1(d)(1) (2007) (“An amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the [employee] otherwise could have elected to receive the . . . compensation, unless the present value of the amount subject to a substantial risk of forfeiture . . . is materially greater than the present value of the amount the [employee] otherwise could have elected to receive absent such risk of forfeiture . . . [f]or example, a salary deferral generally may not be made subject to a substantial risk of forfeiture.”).

\(^{280}\) “Watson Wyatt’s 2002 Nonqualified Deferred Compensation Study . . . surveyed 169 firms, most of which were for-profit, public companies employing an average of 14,900 workers, 55 executives and 468 other managers . . . . Survey highlights include . . . [t]he most common type of [nonqualified plans] are voluntary deferred compensation ([used by] 74 percent [of the participating corporations]), followed by defined benefit excess [IRC] § 401(a)(17) plans (58 percent) and defined benefit excess [IRC] § 415 plans (52 percent).” [http://www.watsonwyatt.com/us/pubs/insider/printable.asp?ArticleID=10500&Component](http://www.watsonwyatt.com/us/pubs/insider/printable.asp?ArticleID=10500&Component) (emphasis added). Thus, 74% of the 169 firms surveyed used elective plans. The study does not indicate how many of those plans contained a substantial risk of forfeiture.


Second, if an employee must comply with a noncompete agreement to receive the NQDC benefits, the IRS regulations do not consider those NQDC benefits subject to a substantial risk of forfeiture.\footnote{\textit{Treas. Reg.} \textsection 1.409A-1(d)(1) (2007) (“An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services.”).} The 409A regulations adopt this position despite a long-standing \textit{IRC \textsection 83} regulation that finds a substantial risk of forfeiture under certain factual circumstances.\footnote{\textit{Id.} \textsection 1.83-3(c)(2) (1978) (“An enforçable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary.”).}

Third, if the employee owns a significant amount of the company’s stock and the NQDC benefits otherwise would be subject to a substantial risk of forfeiture, the 409A regulations may disregarded the risk of forfeiture if it likely will not be enforced.\footnote{\textit{Id.} \textsection 1.409A-1(d)(3) (2007).}

\textbf{B. Aggregation of NQDC Plans for 409A Purposes}

When a company maintains multiple NQDC plans, 409A may treat similar NQDC plans as one plan.\footnote{\textit{Id.} \textsection 1.409A-1(c)(2)(i) (2007).} This is significant because if one NQDC plan document violates 409A, the Terrible Triple Tax may apply to all amounts deferred under multiple documents.

\textbf{EXAMPLE #18.} ABC Company established separate NQDC plans in 1985, 1990, 1995 and 2003. Meredith Middle-Manager and 20 other employees elected to defer compensation under all four plans. Meredith defers amounts into the 2003 plan after 2004, and the company uses the wrong IRS definition of “disability” in the 2003 document (as described in Example #16 of this Article).\footnote{See \textit{supra} notes 230-33 and accompanying text.} As a result of the aggregation rules, this failure to amend will trigger a 409A Plan Failure not only with respect to amounts deferred under the 2003 plan, but also for all...
amounts deferred under the 1985, 1990, and 1995 plans. As a result, Meredith and the 20 other employees all must pay the Terrible Triple Tax on all amounts deferred under the four plans.

The 409A aggregation rules will treat all plans described in one of the following nine categories as one plan under 409A.

1. Elective account balance plans for the deferral of compensation.
2. Account balance plans for the deferral of compensation in which the employee does not make an election.
3. Non-account balance NQDC plans for the deferral of compensation.
4. Separation pay plans.
5. Plans to reimburse expenses or provide in-kind benefits.
7. Deferrals of foreign earned income.
8. Stock rights subject to 409A (as discussed in Part II.C.1 of this Article, 409A provides an enormous loophole for non-discounted stock options).
9. All other NQDC arrangements subject to 409A.

C. Effective Dates, and the 2008 Election

409A applies to:

- amounts deferred in taxable years beginning after December 31, 2004, and
- amounts deferred in taxable years beginning before January 1, 2005 if the NQDC plan is materially modified after October 3, 2004.

---

289 Treas. Reg. § 1.409A-1(c)(2)(E) (2007) discusses “plans . . . to the extent [the] amounts deferred consist of rights to in-kind benefits or reimbursements of expenses, such as membership fees, or expenses related to aircraft or vehicle usage, to the extent that the right to the in-kind benefit or reimbursement, separately or in the aggregate, does not constitute a substantial portion of . . . overall compensation . . . .”
290 See supra notes 108-114 and accompanying text.
Amounts deferred can only be grandfathered if the amount was both earned and vested in a taxable year beginning before January 1, 2005. \(^{294}\) Earnings on deferred amounts are grandfathered if the related deferred amounts are grandfathered. \(^{296}\)

409A will apply to otherwise grandfathered deferrals if there is a “material modification.” \(^{297}\) A modification is a “material modification of a benefit or right existing as of October 3, 2004 [if the benefit or right is] materially enhanced or a new material benefit or right is added, and such material modification or addition affects amounts earned and vested before January 1, 2005.” \(^{298}\) In an important clarification, the final regulations provide:

[T]he grant of an additional benefit under an existing plan that consists of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004, will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation, and provides that the additional deferral of compensation is subject to 409A. \(^{299}\)

Thus, if an employee defers compensation under one NQDC plan both before 2005, and after 2004, the plan document must be amended to “identify[y] the additional deferral of compensation, and provide[] that the additional deferral of compensation is subject to 409A.” \(^{300}\)

The final regulations are not a model of clarity when addressing whether the exercise of a right, or the exercise of discretion, allowed under a pre-October 4, 2004

---

\(^{294}\) Grandfathered amounts are not subject to 409A, and pre-409A law continues to govern those deferrals. See Alvin Lurie, It’s Hard to Find Grandpa in 409A, 104 Tax Notes 229 (2005).

\(^{295}\) An amount was “vested” only if the amount was not subject to a substantial risk of forfeiture [as defined in Treas. Reg. § 1.83-3(c)] and was not subject to a requirement to perform further services. Treas. Reg. § 1.409A-6(a)(2) (2007).


\(^{299}\) Id. § 1.409A-6(a)(4)(ii) (emphasis added).

\(^{300}\) Id.
NQDC plan document will trigger a material modification if exercised after October 3, 2004.

[A material modification can occur] pursuant to an amendment [of the plan] or the [company’s] exercise of discretion under the terms of the plan . . . [A] material modification would occur if the [company] exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004. However, it is not a material modification for [the company] to exercise a right permitted under the plan as in effect on October 3, 2004 . . . . However . . . the exercise of discretion under the terms of the plan that materially enhances an existing benefit or right . . . will be considered a material modification . . . .”

Thus, it appears that an employee could exercise a right allowed in an old NQDC document to extend the date for payment of NQDC benefits and not trigger a material modification, even if the procedure for the extension does not comply with 409A. However, an employee who elects to accelerate a payment, even if that acceleration is permitted under the terms of the old NQDC plan document, likely will trigger a “material modification” (and will have to pay the Terrible Triple Tax) because the acceleration would “enhance an existing benefit or right.”

During 2008, the material modification rule is especially important because taxpayers are given one last chance to amend payment terms without regard to 409A, with some restrictions.

---

301 Id. § 1.409A-6(a)(4)(i) (emphasis added).
302 See IRC § 409A(a)(4)(C) (setting forth the 1 year/1 year/5 year test under 409A, which is discussed in supra Part III.B.).
303 This assumes that the acceleration would violate IRC § 409A. The regulations contain 13 exceptions to the no-acceleration rule. See supra Part IV.
304 IRS Notice 2007-86, § 3.02, 2007-46 I.R.B. 990 (Oct. 22, 2007). The Notice provides in part: [W]ith respect to amounts subject to section 409A, a plan may provide, or be amended to provide, for new payment elections on or before December 31, 2008, with respect to both
VII. CONCLUSION - LAWGIVERS SHOULD CONSIDER COMPLEXITY

“Tax complexity itself is a kind of tax.”

“Needless tax complexity promotes chaos and confusion.”

“There is an ancient belief that the gods love the obscure and hate the obvious. Without benefit of divinity, modern [people] of similar persuasion draft provisions of the Internal Revenue Code.”

When a mistake is made, it creates an opportunity to learn. With that in mind, the 409A Authorities provide a great educational opportunity.

A. Administrative Costs for Small Business, Charities, and Others

Lawgivers should consider the impact on taxpayers, tax advisors and IRS enforcement personnel when creating new laws. 409A will regulate all employers, including small businesses and charities. Those who are aware of the issues, and attempt to comply, will incur significant administrative costs.

EXAMPLE #19: The board of directors of the Einstein Middle School became aware of 409A. The school allows the teachers to annualize their

the time and form of payment of such amounts and the election or amendment will not be treated as a change in the time or form of payment under [IRC §] 409A(a)(4) or an acceleration of a payment under [IRC §] 409A(a)(3), provided that the plan is so amended and elections are made on or before December 31, 2008. . . . [Similar rules apply to an employee’s election in 2006 or 2007.]

Id. § 3.02.
305 The election cannot impact amounts that the company otherwise would pay in 2008. Id.
306 Yablon, supra note 1, at 117 (quoting Max Baucus).
307 Id. at 161 (quoting Gene Steuerle).
308 Id. at 113 (quoting Martin D. Ginsburg).
309 “Previous research has shown that we learn more about things for which we initially make incorrect predictions than from things for which our initial predictions are correct. The element of surprise in discovering we are wrong is conducive to learning.” Physorg.com, Why we lean from our mistakes, available at http://www.physorg.com/printnews.php?newsid=10256501 (discussing research at the University of Exeter).
310 See Johnson, supra note 10, at 582 (“[S]ubstantial emphasis on administrability is important to effective tax simplification.”).
salaries, and allows their employees to accrue vacation and sick leave. The school asks its local attorney to review these arrangements. The attorney is not familiar with 409A and spends considerable time learning the rules, in part because the IRS has refused to provide sample language for complying with 409A. The attorney recommends a formal written plan document governing the procedure for teachers to elect to annualize their compensation. Following the 409A Authorities, the new document requires that teachers make their annualization elections before the beginning of the school year, and that an election to annualize is irrevocable once the school year begins. Also, a school administrator must distribute the “annualization” election forms long before the beginning of the school year, and must follow-up with the teachers to make sure all the election forms are signed and filed before the beginning of the school year.

In addition, the attorney recommends amending the school’s vacation and sick leave policy so that each employee can carry forward fewer days of vacation and sick leave to the next year. All these acts require approval by the school’s governing body in accordance with the school’s normal procedures. The school, the teachers, the administrators, the other employees, and the attorney all must take these steps to protect the teachers and employees from the Terrible Triple Tax.

Attorney’s CPAs, human resource professionals and others will need to spend a lot of time studying Section 409A, its legislative history, the 91-page preamble and final

---

311 Teachers who only work nine months a year typically sign annualization elections to spread their compensation over twelve months. If a school is only in session for nine months, in the absence of an annualization election, a teacher would be paid for nine months and would not receive any compensation for three months. As a result, a teacher who works from September through May typically will elect to defer one-fourth of his or her salary each month from September through May, and the school will pay those deferred amounts ratably from June through August, so that the teacher will receive an equal amount of compensation each month throughout the year. For example, a teacher earning $4,000 per month ($36,000 per year) may elect to be paid $3,000 per month for 12 months, rather than receiving $4,000 per month from September through May and receiving nothing in June, July, and August. The IRS considers this a NQDC arrangement subject to 409A because, in effect, the teacher defers one-fourth of his or her compensation each month in September, October, November and December and does not receive that compensation until the next year. 72 Fed. Reg. at 19254-55 (preamble to final regulations); Treas. Reg. § 1.409A-2(a)(2) (2007); I.R.S. News Release IR-2007-42 (Aug. 7, 2007), Frequently Asked Questions: Section 409A and Deferred Compensation.

312 IRC § 409A(d)(1) excludes “bona fide vacation leave [or] sick leave . . . plan[s].” However, in the 409A regulations, the IRS refuses to provide guidance on when an arrangement is bona fide because of the potential issues involved. 72 Fed. Reg. at 19234. Vacation and sick leave arrangements may be subject to 409A if they allow employees to carry unused vacation or unused sick leave from one year to the next.

313 72 Fed. Reg. at 19250.


315 Id.; see supra note 127 and accompanying text.

316 The final regulations fail to specify how much vacation and sick leave can be carried forward each year. See 72 Fed. Reg. at 19234.
regulations package, the preamble to the proposed regulations, the technical corrections, and the eight IRS notices. Also, the IRS needs to issue additional regulations regarding areas expressly reserved in the final regulations.

Attorneys and others who need to deal with the valid economic arrangements regulated by 409A may not be aware of the issues, and may expose the employees to the Terrible Triple Tax.

**EXAMPLE #20:** Andy Agent, an attorney, works with many professional athletes who prefer to defer a portion of their compensation because they realize that their time as a professional athlete will be limited. Andy drafts the employment contract for a professional basketball player who wants 25% of her compensation for this year to be held by the team and paid to her over 10 years once she terminates employment with the team. However, Andy is not aware of 409A, and includes provisions in the contract that (i) the player will begin receiving payments once she is determined to be “disabled” for purposes of the team’s long-term disability plan, and (ii) the player will begin receiving payments once she terminates employment. This written agreement will trigger a 409A Plan Failure because:

- Andy failed to include the magic 3-month disability rule of IRC § 409A(a)(2)(C), and
- Andy’s use of the phrase “termination of employment” will not comply with the 409A required definition of “separation from service.”

As a result, the athlete will be liable for the Terrible Triple Tax for the year the agreement is signed, on amounts she may not receive for many years.

**B. Additional Problems with Tax Complexity**

---

317 In many situations, the preamble to the final regulations adopts the preamble to the proposed regulations. See e.g., 72 Fed. Reg. at 19236 (“Subject to the modifications described in this section III.C. of the preamble, the final regulations generally adopt the short-term deferral rule that was contained in the proposed regulations.”).

318 See supra note 4.

320 See Treas. Reg. § 1.409A-4; id. § 1.409A-5.

321 See supra note 232.

322 See IRC § 409A(a)(2)(A)(i); Treas. Reg. § 1.409A-3(i)(2) (2007); see supra notes 239-56 and accompanying text.
In addition to taxpayer compliance costs, the complexity of 409A will have other negative consequences. The government has spent substantial time, effort and money to develop the 409A Authorities, and will need to devote significant resources to enforce 409A. If the government cannot effectively enforce 409A, similarly situated taxpayers will not be treated the same, creating greater unfairness in the U.S. tax system.\textsuperscript{323} Even more disturbing, 409A’s complexity may contribute to the erosion of voluntary compliance with our income tax laws. “Complex laws . . . contribute to taxpayer confusion and real or perceived unfairness in the tax system. Studies have shown that taxpayers are less likely to be complaint if they perceive the tax system to be inequitable.”\textsuperscript{324} Tax evasion is already rampant. On average, U.S. taxpayers only pay 85% of the taxes they owe.\textsuperscript{325} Government enforcement is minimal – the IRS audits only 1% of all income tax returns.\textsuperscript{326}

The journey from the 732-page Enron Compensation Report to the 91-page preamble and final regulations package highlights a key rule of the road that lawmakers should observe. The development of a complex regulatory scheme may be a wonderful intellectual game, but lawmakers should consider the practical impact of the rules. Needlessly complex tax laws like 409A frustrate taxpayers, diminish respect for our tax system, reduce voluntary compliance, and exacerbate unfairness. A complex system “that alienates taxpayers undercuts the base of support crucial to the enterprise of American taxation.”\textsuperscript{327} Congress should repeal 409A retroactively because small

\textsuperscript{323} A fundamental policy of the U.S. tax system is that similarly situated taxpayers should be treated the same. Newman, \textit{supra} note 181, at 25.
\textsuperscript{324} Yablon, \textit{supra} note 1, at 114 (quoting George K. Yin).
\textsuperscript{325} Understanding the Tax Gap, \textit{supra} note 8, (“For Tax Year 2001, all taxpayers paid $1.767 trillion on time, a figure that represents from 83.4 percent to 85 percent of the total amount due.”).
\textsuperscript{326} \textit{See supra} note 9.
\textsuperscript{327} Johnson, \textit{supra} note 10, at 581.
businesses and charities should have never been forced to take the 409A road. In the future, lawgivers should consider the negative consequences of complexity so that horrible destinations like 409A can be avoided in the future.