Bloomberg Tax

Tax Management
Compensation Planning Journal™

A Guide to Navigating the Treatment of Bonuses Under §409A (Part 1)

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"It's all in the timing." Johnny Carson

As Joel Grey and Liza Minnelli so memorably sang in *Cabaret*, "Money makes the world go 'round." For many employees, a key component of making money is their bonus. Favorable tax treatment of bonus arrangements turns on navigating the timing and form of payment rules of §409A, which is an arduous and painstaking process.

For employees that rely on their bonus to make more money, and for employers that craft bonus arrangements to motivate employees to make more money for the employer, the process serves as part of God's eternal punishment for Adam and Eve's primordial sin of eating the Garden of Eden's forbidden fruit: man will eat bread by the sweat of his brow.

This article (Part 1) provides a guide to navigating the rules for favorable tax treatment under §409A.[1] It focuses on cash bonuses, and does not address equity compensation.[2] Part 2 will focus on the tax consequences to the employer and employee for an operational violation of §409A. Part 3 will focus on whether under §404, an accrual method employer deducts a bonus in the year the employee performs the services, or in the subsequent year when the employer pays the bonus.

GENERAL REQUIREMENTS OF §409A

Section 409A applies to nonqualified plans of deferred compensation.[3] A plan provides for the deferral of compensation if the employee has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to the employee in a later taxable year.[4] In determining whether an employee has a legally binding right, courts initially look to state law to determine the employee's rights and interests in the property that the government seeks to reach. Once a court makes this determination, federal tax law determines which rights and interests are subject to tax.[5]

Example 1: A bonus plan provides for a bonus to each senior executive officer equal to a certain percentage of the amount of the annual increase in the employer's net profits as shown on the employer's certified financial statements. The plan provides for payment on July 1 of the taxable year after the taxable year in which the net profits were generated and the senior executive officers performed services. The employer chose July 1 because its auditor usually issues the certified financial statements in May.

The §409A regulations provide detailed rules for making initial deferral elections for the time and form of payment. Which rules apply turn on whether the

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[1] All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[2] The §409A regulations provide exemptions from §409A for: (1) incentive stock options, Reg. §1.409A-1(b)(5)(ii); (2) nonqualified stock options and stock appreciation rights that satisfy certain requirements, Reg. §1.409A-1(b)(5)(i); and (3) restricted stock that satisfies certain requirements, Reg. §1.409A-1(b)(6). Restricted stock units are often structured to come within the short-term deferral exemption of Reg. §1.409A-1(b)(4).

[3] §409A(a)(1)(A)(i), §409A(d)(1); Reg. §1.409A-1(a)(1), §1.409A-1(c)(1).

[4] Reg. §1.409A-1(b)(1).

[5] *Sutardja v. United States*, 109 Fed. Cl. 358 (2013) (under California law, vested options give the optionee the legally binding right to purchase shares at a designated price). Under the §409A regulations, an employee can have a legally binding right to compensation regardless of whether the employee is vested in the right. A legally binding right includes a contractual right that is enforceable under governing law regardless of whether the contractual right is conditional or contingent. It also includes an enforceable right created by governing law, such as a statute. Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, §III.B, 72 Fed. Reg. 19,234, 19,236 (Apr. 17, 2007).

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employer or employee makes the deferral decision. For an arrangement in which the employer makes the deferral decision, and that does not provide the employee with an election for the time or form of payment, the employer must designate the time and form of payment by no later than the later of: (1) the time that the employee first has a legally binding right to the compensation; and (2) the time that the employee would have had to make an initial deferral election had the employee been provided with the right to make this election.[6]

For an arrangement in which the employee makes the deferral decision, the arrangement must provide the employee with the right to elect the time of payment, the form of payment, or both the time and form of payment. A deferral election does not include an election for the medium of payment (for example, an election between cash or property).[7] An employee must make an initial deferral election by no later than the latest date provided by the §409A regulations.[8] The latest date turns on the type of deferred compensation plan.

Whether the employer or employee makes the deferral decision, the initial deferral election must provide for payment on one or more of the following six permissible events and times: (1) separation from service;[9] (2) disability;[10] (3) death;[11] (4) at a specified time or pursuant to a fixed schedule;[12] (5) change-in-control;[13] and (6) unforeseeable emergency.[14] The §409A regulations provide detailed definitions of these events and times.

In addition, whether the employer or employee makes the deferral decision, the plan or initial deferral election must provide for the form of payment, such as a single lump sum, a series of installment payments, or a life annuity.[15]

PAYMENT AT A SPECIFIED TIME OR PURSUANT TO A FIXED SCHEDULE

The workhorse for a permissible payment event or time for bonuses is payment at a specified time or pursuant to a fixed schedule.[16] 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 when the amount is deferred.[17] Accordingly, payment at a specified time or fixed schedule has two components: the amount of the payment, and the time of the payment.

An amount is objectively determinable if the amount is specifically identified, or if the amount may be determined when the payment is due pursuant to an objective, nondiscretionary formula specified when the amount is deferred (for example, 50% of a specified account balance). Except as otherwise provided in Reg. §1.409A-3(i)(1), an amount is not objectively determinable if the amount is based all or in part on the occurrence of an event, including the consummation of a transaction by, or a payment of an amount to, the employer.[18]

An amount is payable at a specified time or pursuant to a fixed schedule if it is payable in an employee's taxable year (or pursuant to a fixed schedule of the employee's taxable years) that is designated when the amount is deferred. A specified time or fixed schedule also includes the designation when the amount is deferred over a defined period or periods within the employee's taxable year or taxable years that are objectively determinable. The defined period cannot begin in one taxable year and end in another taxable year.[19]

The §409A regulations also provide for payment on the lapse of a substantial risk of forfeiture, otherwise

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[6] Reg. §1.409A-2(a)(2), §1.409A-2(b)(9) *Ex.* 2.

[7] Reg. §1.409A-2(a)(1).

[8] *Id.* Congress enacted the initial deferral election rules of §409A to vitiate the judicial decisions that narrowed the constructive receipt doctrine and permitted deferral elections shortly before the scheduled payment date. *See* H.R. Rep. No. 108-548, 108th Cong., 2d Sess., Part 1, at 343 (2004).

[9] §409A(a)(2)(A)(i); Reg. §1.409A-1(h), §1.409A-3(a)(1). A plan must provide for a mandatory six-month delay for payments to specified employees on a separation from service. §409A(a)(2)(B)(i); Reg. §1.409A-1(c)(3)(v), §1.409A-3(i)(2). A specified employee is an employee who, as of the date of his or her separation from service, is a key employee of an employer any stock of which is publicly traded on an established securities market or otherwise. §409A(a)(2)(B)(i); Reg. §1.409A-1(i). Because a subsidiary whose parent's stock is traded on a foreign national securities exchange is a public company, an officer of a U.S. subsidiary of a foreign public company can be subject to the six-month delay rule.

[10] §409A(a)(2)(A)(ii), §409A(a)(2)(C); Reg. §1.409A-3(a)(2), §1.409A-3(i)(4). The §409A regulations use one definition of disability as a permissible payment event. They use a different definition of disability as a permissible payment event that does not adversely affect the initial deferral election for performance-based compensation, Reg. §1.409A-1(e), §1.409A-3(a)(8), and as a permissible event for cancellation of deferral elections due to disability, Reg. §1.409A-3(j)(4)(xii).

[11] §409A(a)(2)(A)(iii); Reg. §1.409A-3(a)(3).

[12] §409A(a)(2)(A)(iv); Reg. §1.409A-3(a)(4), Reg. §1.409A-3(b), Reg. §1.409A-3(i)(1).

[13] §409A(a)(2)(A)(v); Reg. §1.409A-3(a)(5), §1.409A-3(i)(5).

[14] §409A(a)(2)(A)(vi), §409A(a)(2)(B)(ii); Reg. §1.409A-3(a)(6), §1.409A-3(i)(3).

[15] Reg. §1.409A-2(a)(1), §1.409A-2(a)(2).

[16] §409A(a)(2)(A)(iv); Reg. §1.409A-3(a)(4), §1.409A-3(i)(1).

[17] Reg. §1.409A-3(i)(1)(i).

[18] *Id.*

[19] *Id.*

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known as a vesting event, as a permissible payment at a specified time or pursuant to a fixed schedule. A plan can provide that the employer will make payments on the lapse of a substantial risk of forfeiture in accordance with a fixed schedule that is objectively determinable based on the date the substantial risk of forfeiture lapses (disregarding any discretionary acceleration of this date). The schedule must be fixed when the time and form of payment are designated, and any change in the schedule will be a change in the time and form of payment.[20] A change in the time or form of payment triggers the anti-acceleration and subsequent deferral election rules.[21]

Because payment on a vesting event is not subject to the prohibition on payment on the occurrence of an event, a bonus arrangement can use a vesting event to satisfy the amount and time of payment components. Accordingly, whether an event is a permissible vesting event becomes the critical determination.

Example 2: A plan provides for payment of a bonus subject to the condition that the employee complete three years of service, and the further condition that the requirement of continued service will lapse on the occurrence of an initial public offering, which condition if applied alone would be a substantial risk of forfeiture. The plan can provide for substantially equal payments on each of the first three anniversaries of the date that the substantial risk of forfeiture lapses (the earlier of three years of service, and the date of an initial public offering). [22]

Because Example 2 states that an initial public offering is a condition, which if applied alone would be a substantial risk of forfeiture, the initial public offering can be a permissible vesting event regardless of whether the employee is employed at the time of the initial public offering.[23] Accordingly, the plan can provide for payment of a bonus when the employee has an involuntary separation from service or voluntary separation from service for good reason, and an initial public offering occurs within a certain number of years after the separation from service.

A critical issue under the §409A regulations is which events are permissible vesting events for the payment of deferred compensation. The answer to this question is explored later in this article.[24]

DISCRETIONARY BONUSES

The §409A regulations provide different analytical frameworks for three types of bonus arrangements: (1) a discretionary bonus initially exempt from §409A; (2) a bonus that qualifies as a short-term deferral exempt from §409A; and (3) a nondiscretionary bonus that is a plan of deferred compensation subject to §409A and that satisfies §409A's timing and form of payment rules.

An arrangement that provides that the employer may award a bonus in its discretion is not a plan of deferred compensation before the employer awards the bonus. An employee does not have a legally binding right to compensation to the extent that the employer or another person may unilaterally reduce or eliminate the compensation after the employee performs the services creating the right to the compensation.[25] Accordingly, a discretionary bonus is initially exempt from §409A.

However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks substantive significance, an employee will be considered to have a legally binding right to the compensation. Whether the discretion to reduce or eliminate the compensation lacks substantive significance turns on all the facts and circumstances.[26]

Example 3: An employment agreement provides that the employer in its exclusive discretion may award the employee a bonus for services performed in a taxable year (Year 1). The employer's board of directors will decide whether to award a bonus in the following taxable year (Year 2) after the board evaluates the employee's and employer's performance in Year 1. The agreement also provides that the board will conduct its evaluation after the auditor issues the certified financial statements for Year 1. The employer will pay any bonus awarded in a single lump sum between 30 days after the date of issuance of the certified financial statements and December 31 of Year 2. Because a discretionary bonus is initially exempt from §409A, the employment agreement does not have to provide for a permissible payment event or time, or the payment of objectively determinable amounts. Had the agreement initially provided for a bonus subject to §409A, the agreement would have had to provide for payment of objectively determinable amounts, and payment on one or more nondiscretionary and

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[20] *Id.*

[21] Reg. §1.409A-2(b)(1), §1.409A-3(j)(1), §1.409A-3(j)(2).

[22] Reg. §1.409A-3(i)(1)(i).

[23] *See* Erica F. Schohn, ''Short-Term Deferrals,'' *Section 409A Handbook* 6-1, 13, *Ex. 3* (Regina Olshan & Erica F. Schohn eds., Bloomberg BNA 2018).

[24] See discussion nn. 161–185, below, and accompanying text.

[25] Reg. §1.409A-1(b)(1).

[26] *Id.*

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objectively determinable dates.[27] The IRS will likely take the position that the date of issuance of the certified financial statements is not a permissible payment date. At the time the parties entered into the agreement, the date of issuance is not a nondiscretionary and objectively determinable date. As in Example 1, the agreement should provide that the employer will pay the bonus on July 1 of Year 2.

Although an employment agreement with a discretionary bonus does not have to specify a permissible payment event or time and form of payment, once the employer decides to pay a bonus, the employee obtains a legally binding right to it. Whether an arrangement provides for the deferral of compensation generally is determined at the time that the employee obtains this right.[28]

Under Example 3, the employee obtains a legally binding right to the bonus in Year 2. Because the employer pays the bonus by no later than December 31 of the same taxable year in which the employee obtains the legally binding right, the arrangement is not a plan of deferred compensation.[29]

Alternatively, the employment agreement can provide that if the employer awards a discretionary bonus, at that time the employer will determine the time and form of payment. The employer can determine to pay the bonus: (1) in the same taxable year in which it awards the bonus so that the arrangement is not a plan of deferred compensation; (2) as a short-term deferral exempt from §409A; or (3) as a plan of deferred compensation that satisfies §409A's timing and form of payment rules.

BONUS AWARDED AS A SHORT-TERM DEFERRAL

Under the short-term deferral exemption from §409A, a deferral of compensation does not occur for any payment that the employee actually or constructively receives on or before the last day of the applicable 2½ month period.[30] An arrangement does not qualify for the short-term deferral exemption if it provides for the employer to make or complete any payment on or after any date under a specified time or schedule, or upon or after the occurrence of any payment event, that will or may occur after the end of the applicable 2½ month period.[31]

Once an arrangement permits a payment outside the applicable 2½ month period, a deferred payment occurs regardless of whether the employer makes the payment within the applicable 2½ month period, or the payment event occurs within the applicable 2½ month period.[32] To qualify the portion of a series of installment payments paid within the applicable 2½ month period for the short-term deferral exemption, the plan must provide that the right to a series of installment payments is to be treated as a right to a series of separate payments.[33] Accordingly, every bonus arrangement should contain a separate payment clause that prophylactically provides for purposes of §409A: (1) each separately identified amount is designated as a separate payment; and (2) any series of installment payments is designated as a right to a series of separate payments, and not one of a series of payments treated as a single payment.[34]

The applicable 2½ month period is the period ending on the later of: (1) the 15th day of the third month after the end of the employee's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture (vested); and (2) the

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[27] Reg. §1.409A-3(i)(1)(i).

[28] Reg. §1.409A-1(a)(1).

[29] Reg. §1.409A-1(b)(1).

[30] Reg. §1.409A-1(b)(4)(i). A payment means each separately identified amount to which an employee is entitled to payment on a determinable date, and includes amounts applied for the employee's benefit. Reg. §1.409A-1(b)(4)(i)(F), §1.409A-2(b)(2)(i). An amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula. For example, an amount identified as 10% of the account balance as of a specified payment date is a separately identified amount. Reg. §1.409A-2(b)(2)(i).

The entitlement to a series of installment payments is treated as the entitlement to 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. Reg. §1.409A-2(b)(2)(iii). A series of installment payments means an entitlement to the payment of a series of substantially equal periodic amounts to be paid over a predetermined period of years, except to the extent any increase (or decrease) in the amount reflects reasonable earnings (or losses) through the payment date. *Id.*

The entitlement to a life annuity is always treated as the entitlement to a single payment. Reg. §1.409A-2(b)(2)(ii)(A). A life annuity means a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the employee, or a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the employee, followed upon the death or end of the life expectancy of the employee by a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the employee's designated beneficiary (if any). *Id.*

Proposed amendments to the §409A regulations provide a rule to determine whether a payment has occurred under all the §409A regulations. Prop. Reg. §1.409A-1(q) (as proposed at 81 Fed. Reg. 40,569, 40,581 (June 22, 2016)).

[31] Reg. §1.409A-1(b)(4)(i)(D).

[32] *Id.*

[33] Reg. §1.409A-2(b)(2)(iii).

[34] For the use of a separate payment clause to protect the ability to make subsequent deferral elections for installment payments, see nn. 138-133, below, and accompanying text.

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15th day of the third month after the end of the employer's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture (vested).[35] In Examples 4 through 9 that follow, assume that both the employer and employee have a calendar taxable year.

Compensation is subject to a substantial risk of forfeiture if: (1) entitlement to the compensation is conditioned on the performance of substantial future services by any person, or the occurrence of a condition related to a purpose of the compensation; and (2) the possibility of forfeiture is substantial.[36] A condition related to a purpose of the compensation must relate to the employee's performance for the employer, or the employer's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value, or completion of an initial public offering).[37]

If an employee's right to the compensation is conditioned on the employee's involuntary separation from service without cause or a voluntary separation from service for a §409A-compliant good reason event, and the possibility of forfeiture is substantial, the right is subject to a substantial risk of forfeiture.[38] In Examples 4 through 9 that follow, assume that the possibility of forfeiture is substantial.

Example 4: An employer establishes a discretionary bonus arrangement on December 15, 2016, for services to be performed in 2017. The employer awards an employee a bonus on July 1, 2018. The employer will pay the bonus in a single lump sum on February 1, 2021, as long as the employee continues employment through December 31, 2020. The employee's right to the payment will no longer be subject to a substantial risk of forfeiture on December 31, 2020. The applicable 2½ month period ends on March 15, 2021. Because the employer will pay the bonus within the applicable 2½ month period on February 1, 2021, the arrangement is a short-term deferral.[39]

Example 5: Under Example 4, the arrangement can also provide that if the employee has an involuntary separation from service before December 31, 2020, the employer will pay the bonus in a single lump sum within 30 days after the date of separation from service.

Because the employer always pays the bonus within 2½ months after the substantial risk of forfeiture lapses, the arrangement is a short-term deferral.[40]

Example 6: On December 15, 2017, the employer establishes a bonus arrangement that provides if any employee increases his or her sales of a particular product in calendar year 2018 by a certain percentage from the employee's sales in calendar year 2017, and the employee is employed on December 31, 2018, the employer will pay the employee a bonus of 20% of the employee's base salary in a single lump sum by March 15, 2019.

Because the employer will pay the bonus within the applicable 2½ month period by March 15, 2019, the arrangement is a short-term deferral.

Example 7: Alternatively, the arrangement in Example 6 provides that the employer will pay the bonus between April 1 and June 30, 2019, and employee must be employed on the date of payment.

Because the date of payment and the lapse of the substantial risk of forfeiture of continued employment through the date of payment occur simultaneously, the employer pays the bonus within the applicable 2½ month period. Accordingly, the arrangement is a short-term deferral.

Example 8: On December 15, 2017, the employer establishes a bonus arrangement that provides if the average annual percentage increase in the employer's net profits from January 1, 2018, through December 31, 2020, exceeds a certain percentage, the employer will establish a bonus pool for its senior executive officers equal to the product of a certain

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[35] Reg. §1.409A-1(b)(4)(i)(A). The §409A regulations permit payment to be made after the applicable 2½ month period and treat the delayed payment as a short-term deferral in three situations: (1) administrative impracticability; (2) payment would jeopardize the employer's ability to continue as a going concern; and (3) disallowance of the employer's compensation deduction under §162(m). Reg. §1.409A-1(b)(4)(ii); §III.C.1, 72 Fed. Reg. 19,234, 19,237 (Apr. 17, 2007). In addition, proposed amendments to the §409A regulations permit delayed payment in the fourth situation of a payment that would violate federal securities laws or other applicable law. Prop. Reg. §1.409A-1(b)(4)(ii).

[36] Reg. §1.409A-1(d)(1).

[37] *Id.*

[38] Reg. §1.409A-1(d)(1). The §409A regulations define separation from service in Reg. §1.409A-1(h), and involuntary separation from service in Reg. §1.409A-1(n)(1).

A voluntary separation from service for good reason that satisfies the definition of a good reason event under the §409A regulations is treated as an involuntary separation. Reg. §1.409A-1(n)(2). One commentator takes the position that regardless of whether the good reason event satisfies this definition, as long as the event creates a substantial risk of forfeiture under Reg. §1.409A-1(d), it should be a permissible vesting event governed by Reg. §1.409A-3(i)(1)(i). Schohn, "Short-Term Deferrals," in *Section 409A Handbook* 6-1, 24-25.

[39] Reg. §1.409A-1(b)(4)(iii), *Exs.* 1, 3.

[40] Schohn, "Short-Term Deferrals," in *Section 409A Handbook* 6-1, 35–36, *Ex. 1*.

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percentage multiplied by the amount of the average annual increase in net profits. The employer will pay each officer a certain percentage of the bonus pool. In addition, the officer must be continuously employed through December 31, 2020. The employer will pay the bonus in a single lump sum between February 1 and March 15, 2021.

Example 9: Alternatively, the arrangement provides that the employer will pay the bonus between April 1 and June 30, 2021, and employee must be employed on the date of payment.

In both Examples 8 and 9, the employer pays the bonus within the applicable 2½ month period. Accordingly, both arrangements are short-term deferrals.

The arrangements in Examples 4 through 9 raise the issue of whether an operational violation of §409A occurs if the employer pays the bonus after the applicable 2½ month period. Although the payment will not qualify as a short-term deferral exempt from §409A, as long as the employer pays the bonus within a period prescribed by the date of payment rules of the §409A regulations, an operational violation of §409A will not occur.

The §409A regulations provide that when an arrangement specifies a payment date, the employer can make payment on that date, or a later date within the same taxable year of the employee. If the employee's taxable year ends less than 2½ months after the specified payment date, the employer can make payment by the 15th day of the third month after the specified payment date. In addition, the employee must not be permitted, directly or indirectly, to designate the taxable year or the payment.[41] If the date of payment under an arrangement is a designated taxable year of the employee, or a period within that taxable year, the specified payment date is the first day of that taxable year, or the first day of the period within that taxable year.[42]

Under these rules, when an arrangement requires the employee to be employed on December 31, and provides that the employer will pay the bonus between the following February 1 and March 15 of the employee's taxable year, the employer can pay the bonus until December 31 of the employee's taxable year without an operational violation.

When an arrangement requires the employee to be employed on the date of payment, and provides for the employer to pay the bonus between April 1 and June 30 of the employee's taxable year, the employer can pay the bonus until December 31 of that year without an operational violation. Furthermore, the employee vests in the bonus on the date of payment. Under the short-term deferral rules, the applicable 2½ month period begins on the date of payment and ends on March 15 of the following taxable year. The employer can pay the bonus until that March 15 and the bonus will qualify as a short-term deferral.[43]

To use the later payment date provided by the §409A regulations without an operational failure, the arrangement must provide for a specified payment date in writing.[44] An arrangement can satisfy the short-term deferral exemption without a specified payment date in writing as long as the employer makes the payment within the applicable 2½ month period.[45] However, if the arrangement does not have a specified payment date in writing, the employer cannot use the later payment date to avoid an operational violation. Accordingly, every bonus arrangement that seeks to come within the short-term deferral exemption should prophylactically provide for a specified payment date in writing. In this manner, if the employer does not make the payment within the applicable 2½ month period, it can use the later payment date permitted by the §409A regulations to avoid an operational violation.

Avoiding a Claim for Breach of Contract: Although the employer can avoid an operational violation for a payment made after a designated payment date, or after the applicable 2½ month period for a short-term deferral, under the common law of contracts the delayed payment may be a breach of contract. To avoid a claim for breach of contract, the employer should consider providing in the bonus arrangement that as long as the employer makes a payment within the period permitted by the §409A regulations, the employer does not breach the contract and the employee does not have a claim for damages.

However, employees with the leverage to negotiate for the payment of separation benefits on a voluntary separation from service for good reason usually resist any provision that permits payment by the employer after the designated payment date but within the period permitted by the §409A regulations. Moreover, these employees often negotiate for the §409A-compliant good reason event of the employer's failure to pay base salary or bonus within 30 days after the designated payment date, and continuation of the failure after the employee gives the employer written notice and a reasonable opportunity to cure.[46]

Regardless of whether a payment made after the applicable 2½ month period satisfies the date of pay-

[41] Reg. §1.409A-3(d).

[42] *Id.*

[43] Reg. §1.409A-1(b)(4)(iii) *Ex.* 4.

[44] Reg. §1.409A-1(c)(3)(i), §1.409A-3(b)–§1.409A-3(d).

[45] Reg. §1.409A-1(b)(4)(iii) *Exs.* 1–3.

[46] *See* Reg. §1.409A-1(n)(2)(i) (general definition of voluntary

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ment rules, the payment generally will not satisfy the short-term deferral exemption from §409A.[47] As an exempt payment, a short-term deferral is not subject to the six-month delay rule for payments to specified employees on separation from service.[48] In Example 5, loss of short-term deferral status means that when the employer makes a payment to a specified employee on separation from service after the applicable 2½ month period, the payment is subject to the six-month delay rule.

Furthermore, because a short-term deferral is exempt from §409A, it is not subject to the anti-acceleration rules.[49] Accordingly, acceleration of the bonus in Examples 4 through 9 is permissible at any time and for any reason. Acceleration is permissible regardless of whether the arrangement: (1) gives the employer the discretion to accelerate; (2) requires the employer to obtain the employee's consent to accelerate; or (3) is silent on acceleration and under the common law of contracts the employer must obtain the employee's consent and give the employee additional consideration.[50]

Moreover, if acceleration of a short-term deferral occurs on a change-in-control event, the event does not have to be a §409A-compliant change-in-control event that would otherwise apply to an arrangement subject to §409A.[51] A major impetus for the enactment of §409A was the acceleration of distributions by Enron executives from their nonqualified deferred compensation plans.[52] One commentator has pointed out that the ability to accelerate short-term deferrals is inconsistent with Section 409A's purpose:

> The following is an example of the idiosyncrasies of §409A. An employer promises an executive in 2007 to pay the executive in 2011 a large sum, but only if the executive works until 2011. Then, the employer changes its mind, waives the continuing service condition and ''vests'' and pays the sum earlier to the employee. Section 409A does not apply. Compare this result to the situation where the employer promises in 2007 to pay the executive in 2011 in all events (read ''vested'') a large sum. Under §409A, if the employer accelerates the payment date of this large sum to any date prior to 2011, §409A sanctions may apply. Why does this occur? Primarily, this occurs because §409A applies only to NDC [nonqualified deferred compensation], and the Treasury has adopted a definition of NDC that treats the former promise as not providing such compensation.
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> So, if Enron were to repeat, Enron could pay its executives any amount it had not promised to pay, as well as any amounts that it promised to pay but that were ''unvested,'' without running afoul of §409A. Only amounts that were or are to be paid after ''vesting'' are subject to §409A sanctions. To emphasize, amounts earned and vested for prior service can't be paid, but unearned prior awards and new awards can be paid![53]

EMPLOYEE INITIAL DEFERRAL ELECTIONS

The three employee initial deferral elections that often apply to a discretionary bonus awarded as a short-term deferral are the elections: (1) under the general rule;[54] (2) for short-term deferrals;[55] and (3) for arrangements with certain forfeitable rights.[56] In addition, the deferral election for the first year of eligibility to participate can apply.[57]

When a bonus arrangement satisfies the requirements for more than one initial deferral election, the employer can offer the employee one or more of these elections. Under the §409A regulations, an initial deferral election is permissible if the plan permits the employee to elect to defer compensation for services performed in an employee's taxable year, and any election made becomes irrevocable ''not later than the

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separation from service for good reason).

[47] For the situations that the §409A regulations permit payment to be made after the applicable 2½ month period and treat the delayed payment as a short-term deferral, *see* n. 35, above.

[48] §409A(a)(2)(B)(i); Reg. §1.409A-1(c)(3)(v), §1.409A-3(i)(2).

[49] §409A(a)(3); Reg. §1.409A-3(j)(1).

[50] *See, e.g., Best Buy Builders, Inc. v. Siegel*, 409 S.W.3d 562, 565 (Mo. Ct. App. 2013) (when the parties modify an existing contract, they are making a new contract; the new contract is enforceable only if there is mutual assent and consideration).

[51] For the definition of §409A-compliant change-in-control events, see nn. 92–101, below.

[52] As Enron executives became aware of their company's impending collapse, 127 executives accelerated more than $53 million in distributions from nonqualified deferred compensation plans in the weeks before Enron's bankruptcy filing. At the same time, during a 2½ week blackout period in the Enron 401(k) plan, rank-and-file employees were unable to sell their Enron stock in the 401(k) plan as the stock's price fell from $15.40 to $9.98. Because Enron made matching contributions in Enron stock, nearly 70% of 401(k) plan participants were invested in Enron stock. Staff of the Joint Committee on Taxation, 108th Congress, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations*, JCS-3-03, at 38, 621–25 (Feb. 28, 2003).

[53] James R. Raborn, ''Executive Compensation: Much Ado About . . . .,'' 10 *Houston Business & Tax Law Journal* 262, 284 (2010).

[54] §409A(a)(4)(B)(i); Reg. §1.409A-2(a)(3).

[55] Reg. §1.409A-2(a)(4), §1.409A-2(b)(9) *Ex.* 6.

[56] Reg. §1.409A-2(a)(5), §1.409A-2(b)(9) *Ex.* 5.

[57] §409A(a)(4)(B)(ii); Reg. §1.409A-2(a)(7).

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latest date permitted'' under Reg. §1.409A-2(a).[58] The use of the term ''latest'' shows that the employer can offer the employee one or more of the 11 initial deferral elections under Reg. §1.409A-2(a) that apply to the arrangement.

In determining whether an arrangement is a short-term deferral, if the arrangement gives the employee or employer the right to make a deferral election that results in a different payment date, schedule, or event than the arrangement otherwise provides, the right to make the election is disregarded. Whether an arrangement is a short-term deferral or a deferred payment is determined by the payment date, schedule, or event that would apply in the absence of a deferral election.[59] If the arrangement would not have provided for a deferred payment in the absence of a deferral election, and the employee or employer makes an election, whether the arrangement is a short-term deferral or a deferred payment is determined by the payment date, schedule, or event that the employee or employer elects.[60]

In Examples 4 through 9, should the employer wish to provide the employee with an initial deferral election, the election will result in a payment that will be made after the last day of the applicable 2½ month period and the loss of the short-term deferral exemption. The loss of the exemption means that the employer loses the unrestricted ability to accelerate payments, and in Example 5, payment to a specified employee on separation from service is subject to the six-month delay rule.

Under the general rule for initial deferral elections, the employee must make the election by the close of the taxable year before the year that the employee performs the services for which the employer awards the bonus.[61] The general rule applies to a discretionary bonus even though the employee does not have a legally binding right to the bonus until the employer awards the bonus after the taxable year in which the employee performs the services.[62] To address the uncertainty of the size of any discretionary bonus ultimately awarded, an arrangement can permit an employee to defer a certain percentage of the bonus, or a certain amount or percentage in excess of a set dollar amount.

In Examples 4 and 5, under the general rule the employer can offer the employee the right to make an initial deferral election by December 31, 2016. This date is the close of the 2016 taxable year before the 2017 taxable year that the employee performs the services for which the employer awards the bonus.

Under the initial deferral election rule for short-term deferrals, the election may be made in accordance with the subsequent deferral election rules, which are applied as if the short-term deferral was deferred compensation, and the scheduled payment date was the date that the substantial risk of forfeiture lapses.[63] The election has three requirements.[64] First, the election cannot take effect until at least 12 months after the date on which the employee makes the election. Second, the payment must be deferred for at least five years from the date the payment would otherwise have been made, and for a life annuity or installment payments treated as a single payment, five years from the date the first amount was scheduled to be paid. Third, for a payment made at a specified time or pursuant to a fixed schedule, the employee must make the election at least one year before the first payment date.[65]

An employee's deferral election can provide that the amount deferred will be paid on a change-in-control (as defined in Reg. §1.409A-3(i)(5)) regardless of the five-year deferral requirement. Thus, deferral of the payment of a short-term deferral until a change-in-control requires a §409A-compliant definition of change-in-control, but acceleration of the payment of a short-term deferral on a change-in-control does not. The exception to the five-year deferral requirement for a §409A-compliant change-in-control is in addition to the general exceptions to this requirement for death, disability, and unforeseeable emergency.[66]

In Examples 4 and 5, the employer can permit the employee to make an election before February 1, 2020, which is at least 12 months after the date on which the employee makes the election, and one year before the first payment date. In addition, the election must defer payment for at least five years from the date the payment would otherwise have been made. Therefore, the election must defer payment from February 1, 2021, to February 1, 2026 or a later date.

The election can permit payment before February 1, 2026, on a change-in-control that satisfies the definition under Reg. §1.409A-3(i)(5). In addition, the §409A regulations permit acceleration of payment on death, disability, or unforeseeable emergency.[67] Ac-

[58] Reg. §1.409A-2(a)(1).

[59] Reg. §1.409A-1(b)(4)(i)(D).

[60] *Id.*

[61] §409A(a)(4)(B)(i); Reg. §1.409A-2(a)(3).

[62] Reg. §1.409A-2(a)(1); §VI.A, 72 Fed. Reg. 19,234, 19,251 (Apr. 17, 2007).

[63] Reg. §1.409A-2(a)(4), §1.409A-2(b)(1).

[64] Reg. §1.409A-2(b)(1).

[65] *Id.*

[66] Reg. §1.409A-2(b)(1)(ii).

[67] Reg. §1.409A-3(j)(2). The §409A regulations currently per-

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cordingly, the election can permit payment if any of these events occur before February 1, 2026.[68]

Furthermore, in Example 5, the payment on an earlier involuntary separation from service can remain in place. The §409A regulations provide that when an arrangement that permits a payment on each of a number of permissible payment events, such as the earlier of fixed date and separation from service, the subsequent deferral election rules are applied separately to each payment due on each payment event.[69]

However, the addition or deletion of a permissible payment event that may result in a change in the time or form of payment is subject to the subsequent deferral election rules.[70] Furthermore, the addition or deletion of a permissible payment event, or the substitution of one permissible payment event for another, is subject to the anti-acceleration rules if the addition, deletion, or substitution could result in the payment being made at an earlier date than the payment would have been made absent the addition, deletion, or substitution.[71]

Accordingly, in Example 4, should the employee wish to add involuntary separation from service as a payment event, the employee's deferral election must provide for payment on the later of February 1, 2026 (or a later date), and the date of separation from service.[72]

The initial deferral election for certain forfeitable rights applies when an arrangement provides the employee with a legally binding right to a payment in a later taxable year. To avoid forfeiture of the payment, the arrangement must require the employee to perform services for at least 12 months from the date the employee obtains the legally binding right. The employee must make the deferral election: (1) on or before the 30th day after the employee obtains the legally binding right; and (2) at least 12 months before the earliest date on which the forfeiture condition could lapse (the vesting date).[73]

Under these rules, for the employee to have 30 days to make the deferral election, at least 12 months plus 30 days must pass before the earliest possible vesting date. As a result, the initial deferral election for certain forfeitable rights is known as the ''13-month rule.'' When an amount of compensation is subject to at least a 13-month vesting period, the employee can make the deferral election within 30 days after obtaining the legally binding right to the compensation. When the vesting period is 12 months, the employee must make the deferral election before the date that the employee obtains the legally binding right to the compensation.

A forfeiture condition will not be treated as failing to require the employee to perform services for at least 12 months because the condition immediately lapses on the employee's death, disability (as defined in Reg. §1.409A-3(i)(4)), or a change-in-control (as defined in Reg. §1.409A-3(i)(5)). If death, disability, or a change-in-control occurs and the service requirement lapses before the end of the 12-month period, a deferral election will be effective only if it is otherwise permitted under Reg. §1.409A-2 without regard to the deferral election for certain forfeitable rights.[74]

In Example 4, the employee obtains a legally binding right to the bonus on July 1, 2018, and the employee must perform services through December 31, 2020. The employer can permit the employee to make a deferral election on or before July 31, 2018, which is within 30 days after the employee obtains the legally binding right. Because the employee must perform services through December 31, 2020, the employee must perform services for at least 12 months after July 31, 2018.[75]

If the employer permits the service requirement to lapse before July 31, 2019, due to death, disability, or a change-in-control that occurs before July 31, 2019, the deferral election for certain forfeitable rights will no longer be effective. In this situation, the deferral election will be effective only if it is otherwise permitted under Reg. §1.409A-2. Under the general rule, the employee had to make an election by December 31, 2016. Under the short-term deferral rule, the employee had to make the election at least 12 months before the substantial risk of forfeiture lapses. Because the employee made the election on July 31, 2018, the service requirement could not lapse before July 31, 2019. Accordingly, the deferral election is not otherwise permitted under Reg. §1.409A-2.

Furthermore, in Example 5, the employer pays the bonus if the employee has an involuntary separation from service after July 31, 2018, and before December 31, 2020. Therefore, as of July 31, 2018, the employee cannot make a deferral election at least 12 months before the earliest date on which the service requirement could lapse. Accordingly, the deferral election for certain forfeitable rights is unavailable.

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mit acceleration on the employee's death, disability, or unforeseeable emergency. Proposed amendments to the §409A regulations permit acceleration on the employee's beneficiary's death, disability, or unforeseeable emergency that occurs after the employee's death. Prop. Reg. §1.409A-3(j)(2).

[68] Reg. §1.409A-2(a)(4), §1.409A-2(b)(9) *Ex.* 6.

[69] Reg. §1.409A-2(b)(6).

[70] Reg. §1.409A-2(b)(6), §1.409A-3(j)(2).

[71] Reg. §1.409A-3(j)(2).

[72] Reg. §1.409A-2(b)(9) *Ex.* 22.

[73] Reg. §1.409A-2(a)(5).

[74] *Id.*

[75] Reg. §1.409A-2(b)(9) *Ex.* 5.

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Finally, the initial deferral election for certain forfeitable rights permits accelerated vesting while keeping the original payment date. In Example 4, the employer can accelerate vesting and permit the service requirement to lapse at any time after July 31, 2019. The arrangement would continue to provide for the same payment date of February 1, 2021.

INITIAL DEFERRAL ELECTION FOR FIRST YEAR OF ELIGIBILITY TO PARTICIPATE

For the first year in which an employee is eligible to participate in a plan, the following initial deferral election applies. The employee can make an initial deferral election within 30 days after the date that the employee becomes eligible to participate in the plan with respect to compensation paid for services to be performed after the election. For a plan that does not provide for employee elections for the time and form of payment, the employer must specify time and form of payment on or before the date that is 30 days after the date that the employee first becomes eligible to participate.[76]

For compensation that is earned based on a specified performance period (for example, an annual bonus), when an employee makes a deferral election in the first year of eligibility but after the beginning of the performance period, the election applies only to the compensation paid for services performed after the election. An election is deemed to apply to compensation for services performed after the election if the election applies to no more than an amount equal to the total amount of the compensation for the performance period 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.[77]

The first year of eligibility rule usually applies to newly hired employees, newly adopted plans, and employees who first become eligible to participate in a plan due to a promotion or transfer. In Example 4, assume that the employer hires an employee on July 1, 2017, and the employee is immediately eligible to participate in the bonus arrangement. The employee can make a deferral election by July 31, 2017, for compensation earned for services performed from September 1, 2017, to December 31, 2017.

For a plan that does not provide for employee elections for the time and form of payment, it is an unresolved issue as to whether the employer's deferral election is limited to the compensation paid for services performed after the election, or compensation earned after the employee becomes eligible to participate.[78]

The requirement that the election apply only to compensation paid for services performed after the election means that if the employer does not choose the employees to receive a discretionary bonus until after the taxable year that the employees performed the services to which the bonus relates, the first year of eligibility election is unavailable. When the employer chooses the employees during the year that they perform services, the first year of eligibility election is available.

An employee is eligible to participate in a plan at any time during which, under the plan's terms and without further amendment or action by the employer, the employee is eligible to accrue an amount of deferred compensation under the plan other than earnings on amounts previously deferred, even if the employee has elected not to accrue (or has not elected to accrue), an amount of deferred compensation.[79]

The determination of an employee's first year of eligibility to participate in a plan is subject to the plan aggregation rule. Under this rule, plans classified as similar under the §409A regulations are aggregated and treated as a single plan.[80] For example, an elective salary deferral plan and an elective bonus deferral plan are aggregated and treated as a single plan.[81] Accordingly, if an employee already participates in an elective salary deferral plan, and the employer subsequently establishes an elective deferral plan for long-term incentive bonuses, the first year of eligibility election is unavailable for the second plan.[82]

BONUS AWARDED AS A PLAN OF DEFERRED COMPENSATION

The employer can also award a discretionary bonus as a nonqualified plan of deferred compensation subject to §409A.

Example 10: An employer establishes a discretionary bonus arrangement on December 15, 2016, for services to be performed in 2017. The employer awards a bonus on July 1, 2018, and elects at the time of the award to pay the bonus in three equal annual installments on September 1 of 2018, 2019, and 2020. If a §409A-compliant change-in-control event occurs before September 1, 2020, the em-

[76] §409A(a)(4)(B)(ii); Reg. §1.409A-2(a)(7).

[77] Reg. §1.409A-2(a)(7)(i).

[78] Regina Olshan, ''Initial Deferral Elections,'' in *Section 409A Handbook* 8-1.

[79] Reg. §1.409A-2(a)(7)(ii).

[80] Reg. §1.409A-1(c)(2)(i).

[81] Reg. §1.409A-1(c)(2)(i)(A).

[82] §VI.D., 72 Fed. Reg. 19,234, 19,252 (Apr. 17, 2007).

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ployer will pay all remaining installments in a single lump sum within 30 days after the date of the change-in-control. Furthermore, the employee will forfeit all unpaid installments if after July 1, 2018, the employee violates covenants for noncompetition, nondisclosure of confidential information, or nonsolicitation of employees and customers. The employer will pay the installments and the covenants will continue in effect regardless of whether the employee separates from service.

VESTED STATUS OF DEFERRED COMPENSATON

Under the §409A regulations, deferred compensation is not subject to a substantial risk of forfeiture (vested) if the right to the compensation is conditioned, directly or indirectly, on refraining from the performance of services.[83] In Example 10, the noncompetition covenant does not change the vested status of the bonus on July 1, 2018. The nondisclosure and nonsolicitation covenants are analogous to the noncompetition covenant because the employee's compliance with these covenants is within the employee's control.[84] Accordingly, the nondisclosure and nonsolicitation covenants should not change the vested status of the bonus on July 1, 2018.

The §409A regulations do not treat the forfeiture of deferred compensation for violation of the covenants as a payment of deferred compensation.[85] Accordingly, the forfeiture will not run afoul of the anti-acceleration and subsequent deferral election rules.

Be Wary in Drafting Covenants: In drafting the covenants, tax counsel should be wary of arrangements that give the employer the discretion to determine whether the employee forfeits the deferred compensation on the employee's violation of the covenants. The IRS will likely view the grant of discretion as running afoul of the rule for payments at a specified time or pursuant to a fixed schedule. This rule requires that objectively determinable amounts be payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred.[86] Forfeiture of payments in the employer's discretion likely means that the payment dates are not nondiscretionary and objectively determinable at the time the amount is deferred. The IRS will likely also take the same position for arrangements that give the employer the discretion to determine whether the employee has violated the covenants.

EMPLOYER'S INITIAL DEFERRAL ELECTION

When an arrangement defers compensation for services performed in an employee's taxable year, and does not give the employee the right to elect the time or form of payment, the employer must make its deferral election for the time and form of payment by no later than the later of: (1) the time the employee first has a legally binding right to the compensation; and (2) the time the employee had to have made an initial deferral election had the employee been provided with an initial deferral election.[87]

The two employee initial deferral elections that often apply are: (1) the general rule; and (2) arrangements with certain forfeitable rights. In addition, the deferral election for the first year of eligibility to participate can apply. The advantage of the **employer's** deferral election over the **employee's** deferral election is that if the employer awards a discretionary bonus after the performance period, the employer can make an initial deferral election while the employee cannot.

In Example 10, the employee first has a legally binding right to the compensation when the employer awards the discretionary bonus on July 1, 2018. Under the general rule for initial deferral elections, the employee had to make his or her election by no later than the close of the taxable year before the taxable year that the employee performs services, which is December 31, 2016. The December 31, 2016, date is before the July 1, 2018, date.

The employee's initial deferral election for certain forfeitable rights applies when the arrangement requires the employee to perform services for at least 12 months after the date that the employee obtains the legally binding right to a payment in a later taxable year. The employee obtains the legally binding right to the bonus on July 1, 2018. Because the employee is vested in the bonus on July 1, 2018, the employee does not have to perform services to avoid forfeiture of the bonus. As a result, the employee's initial deferral election for certain forfeitable rights does not apply.

Accordingly, the employer can make an initial deferral election on July 1, 2018, the time the employee first has a legally binding right to the bonus.

If the arrangement in Example 10 at all times provides that the right to the installment payments is to be treated as a right to a series of separate payments,

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[83] Reg. §1.409A-1(d)(1).

[84] *See* §V.A., 72 Fed. Reg. 19,234, 19,251 (Apr. 17, 2007) (''Generally, conditions under the discretionary control of the service provider (other than the decision whether or not to continue providing services) are not treated as creating a substantial risk of forfeiture.'').

[85] Reg. §1.409A-3(f).

[86] Reg. §1.409A-3(i)(1).

[87] Reg. §1.409A-2(a)(2), §1.409A-2(b)(9), *Ex.* 2.

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the installment paid on September 1, 2018, comes within the applicable 2½ month period ending on March 15, 2019. This installment is a short-term deferral, and the employer has the unrestricted right to accelerate payment of this installment. If the arrangement does not provide for the treatment of installment payments as separate payments, then all the installments are treated as a single payment, and none of the installments qualifies as a short-term deferral.[88]

Under the §409A regulations, an arrangement can provide for a form of payment for each payment event that is different from the form of payment for any other payment event.[89] Accordingly, in Example 10 the payment of three equal annual installments on a fixed schedule, and the payment of a lump sum on a change-in-control, are permissible. In addition, on a change-in-control acceleration of the remaining installments then being paid on the fixed schedule is permissible.[90] Finally, the payment within 30 days after the date of the change-in-control qualifies as a payment on a change-in-control.[91]

§409A-COMPLIANT DEFINITION OF CHANGE-IN-CONTROL

A §409A-compliant definition of change-in-control must use one or more of the following four events:[92]

- Any one 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 corporation's stock (a ''change in the ownership of a corporation'');[93]
- Any one person, or more than one person acting as a group, acquires (or has acquired in the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 30% or more of the total voting power of the corporation's stock (a ''change in the effective control of a corporation'');[94]
- A majority of members of the corporation's board of directors is replaced in 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 (a ''change in the effective control of a corporation'');[95] and
- Any one person, or more than one person acting as a group, acquires (or has acquired in the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40% of the total gross fair market value of all the assets of the corporation immediately before such acquisition or acquisitions (a ''change in the ownership of a substantial portion of a corporation's assets'').[96]

The corporation that undergoes the change-in-control event must be one of the following three corporations:

(1) The corporation for which the employee is performing services at the time of the change-in-control event;[97]

(2) The corporation liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable), but only if either the deferred compensation is attributable to the performance of services

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[88] *See* Reg. §1.409A-1(b)(4)(iii) *Ex.* 7, §1.409A-2(b)(2)(iii).

[89] Reg. §1.409A-3(a), §1.409A-3(b).

[90] Reg. §1.409A-3(j)(1).

[91] Reg. §1.409A-3(b).

[92] Reg. §1.409A-3(i)(5)(i) .

[93] Reg. §1.409A-3(i)(5)(v).

[94] Reg. §1.409A-3(i)(5)(vi)(A)(1), §1.409A-3(i)(5)(vi)(D); *see also Luther v. Navistar Int'l Corp.*, No. 15 C 3120, 2018 BL 93978 (N.D. Ill. Mar. 19, 2018) (a group must acquire 30% of a company's shares within a 12-month period, and not simply exceed the 30% ownership cap; Executive Severance Agreement provided for severance benefits if a 409A change-in-control occurred within 24 months before executive's termination; the highest percentage of Navistar stock that the MHR Group acquired within any 12-month period between June 2012 and June 2014 was 14.98%; the highest percentage of Navistar stock that the Icahn Group acquired during any 12-month period was 14.94%; the combined percentage shares that the group purchased in a 12-month period did not exceed 30%).

Luther v. Navistar, Inc., No. 15 C 3120, 2017 BL 107529 (N.D. Ill. Mar. 31, 2017) (under Treas. Reg. §1.409A-3(i)(5)(vi)(D), persons do not act as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering; however, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase, or acquisition of stock, or similar business transaction with the corporation; court held that it is reasonable to conclude that the second sentence of the regulation, beginning with the word ''however,'' is intended to provide an example, not necessarily an exclusive definition; the term ''group'' under the regulation has the same meaning as under the Williams Act, 15 U.S.C. §78m(d)(3) and §78n(d)(2); once it is shown that a group has agreed to pursue a common objective, and once it is further shown that a member of the group has thereafter purchased additional shares of the corporation's stock, then a rebuttable presumption arises that the purchase was made pursuant to an agreement of the group as of that date to acquire shares in furtherance of its objectives).

[95] Reg. §1.409A-3(i)(5)(vi)(A)(2).

[96] Reg. §1.409A-3(i)(5)(vii).

[97] Reg. §1.409A-3(i)(5)(ii)(A)(1).

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by the employee for such corporation (or corporations), or there is a bona fide business purpose for such corporation or corporations to be liable for such payment. In either case, the avoidance of federal income tax cannot be a significant purpose for making such corporation or corporations liable for the payment;[98] or

(3) A corporation that is a majority shareholder of a corporation identified in paragraph (1) or (2) above, or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in paragraph (1) or (2) above.[99] A majority shareholder is one that owns more than 50% of the total fair market value and total voting power of a corporation.[100]

For a change in the effective control of a corporation, the corporation that must undergo the change-in-control is the relevant corporation identified in paragraphs (1)-(3) for which no other corporation is a majority shareholder.[101]

PERMISSIBLE MODIFICATIONS TO AND EXTENSIONS OF VESTING CONDITIONS ON A CHANGE-IN-CONTROL

Generally, the addition of a risk of forfeiture once the employee has a legally binding right to the compensation, or an extension of the period in which the compensation is subject to a substantial risk of forfeiture (a vesting condition), is disregarded in determining whether the compensation is subject to a substantial risk of forfeiture (nonvested).[102] The §409A regulations provide an exception for modifications to and extensions of vesting conditions for nonvested compensation on the two §409A-compliant change-in-control events of a change in the ownership of a corporation, and a change in the ownership of a substantial portion of a corporation's assets.[103] The exception does not apply to a change in the effective control of a corporation.

Under the exception, a substantial risk of forfeiture that would otherwise lapse on a change-in-control event can be modified or extended before and in connection with the event to provide for a vesting condition that does not lapse.[104] The exception applies if: (1) the change-in-control event is a bona fide arm's length transaction between the employer or its shareholders, and one or more parties unrelated to the employer and employee; and (2) the modified or extended condition would otherwise be treated as a substantial risk of forfeiture under Reg. §1.409A-1(d) without regard to the rule disregarding additions to or extensions of forfeiture conditions.[105]

When an arrangement provides for payments at a specified time or pursuant to a fixed schedule triggered by the date that a substantial risk of forfeiture lapses (the vesting date), determination of this date is critical. If payments are made on a new date triggered by an impermissible modification or extension of a risk of forfeiture, a violation of the anti-acceleration rules or subsequent deferral election rules can occur. Under the exception, the modification or extension of a substantial risk of forfeiture does not run afoul of either set of rules. In addition, if the bonus originally qualified as a short-term deferral, the modified bonus will also qualify.[106]

Other than to the extent that payment would otherwise occur on the lapse of a substantial risk of forfeiture, the exception does not permit any other change in the timing or form of payment. Finally, for deferred compensation that is already vested before the change-in-control event, the exception does not permit any change or waiver of the compensation's vested status, and in the time and form of payment.

Example 11: An employee has a legally binding right to the payment of a deal bonus equal to 1% of the purchase price in excess of a threshold amount on the sale of all the employer's stock. The bonus is payable in a lump sum within 30 days after closing. The vesting condition is continued employment through closing.

Before and in connection with the sale, the buyer and employee want to modify the deal bonus to provide for payment only if the employee remains employed by the buyer for two years after the sale. The buyer and employee can modify the deal bonus to provide for payment of the bonus in a lump sum within 30 days after the employee completes two years of service with the buyer. The modification can also provide for payment of the bonus in a lump sum within 30 days after the earlier vesting events of an involuntary separation from service or a voluntary separation from service for a §409A-compliant good

[98] Reg. §1.409A-3(i)(5)(ii)(A)(2).
[99] Reg. §1.409A-3(i)(5)(ii)(A)(3).
[100] Reg. §1.409A-3(i)(5)(ii)(B).
[101] Reg. §1.409A-3(i)(5)(vi)(A)(2).
[102] Reg. §1.409A-1(d)(1).
[103] Reg. §1.409A-3(i)(5)(iv)(B).
[104] *Id.*
[105] *Id.* The related party determination is governed by Reg. §1.409A-1(f)(2)(ii).
[106] *Id.*

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reason event.[107] However, the buyer and employee cannot allow the bonus to vest on the sale and defer payment for two years without running afoul of the subsequent deferral election rules.

PERMISSIBLE DELAY IN PAYMENT OF TRANSACTION-BASED COMPENSATION ON A CHANGE-IN-CONTROL

The §409A regulations permit a delay in the payment of transaction-based compensation in two situations. These rules apply to the §409A-compliant change-in-control events of a change in the ownership of a corporation, and a change in the ownership of a substantial portion of a corporation's assets.[108] They do not apply to a change in effective control of a corporation. Transaction-based compensation means payments made to an employee because the employer purchases its stock held by the employee; the employer or a third party purchases a stock right held by the employee; or, payments are calculated by reference to the value of the employer's stock.[109]

Under the first permissible delay rule, transaction-based compensation is treated as paid on a designated date or pursuant to a §409A-compliant payment schedule if it is paid on the same schedule and under the same terms and conditions that apply to payments to the shareholders generally, and within five years after the change-in-control event.[110] The payment arrangement does not run afoul of the initial or subsequent deferral election rules.

The following variation on Example 11 illustrates this rule. The employer and buyer establish an escrow of 10% of the purchase price to indemnify the buyer for the employer's pre-closing contingent liabilities. If the employer does not incur the liabilities in the three years after closing, the escrowed funds are released to the employer's shareholders according to a schedule over the three years as provided in the stock purchase agreement.

The employer, employee, and buyer agree that 10% of the employee's deal bonus will be subject to the escrow. The balance of the deal bonus will continue to be paid in a lump sum within 30 days after closing in accordance with its original terms. Because the 10% of the employee's deal bonus will be paid on the same schedule and under the same terms and conditions that apply to the employer's shareholders generally, and within five years after the sale of stock, the agreement does not run afoul of the initial or subsequent deferral election rules.

Under the second permissible delay rule, the addition of a new substantial risk of forfeiture to transaction-based compensation and payment of the compensation after the change-in-control event can make the compensation a short-term deferral. Treatment as a short-term deferral occurs regardless of whether the compensation initially was a short-term deferral. This result is achieved by applying the short-term deferral rules as if the legally binding right to the transaction-based compensation arose on the date that the compensation became subject to the new substantial risk of forfeiture, rather than on the date that the arrangement was established.[111]

The four requirements for short-term deferral treatment are: (1) the transaction-based compensation would otherwise be payable on the change-in-control event; (2) the addition of the substantial risk of forfeiture occurs before and in connection with the change-in-control event; (3) the substantial risk of forfeiture satisfies the requirements of Reg. §1.409A-1(d) without regard to the provisions disregarding additions to or extensions of forfeiture conditions; and (4) the transaction-based compensation is payable under the same terms and conditions as apply to payments made to the shareholders generally. The five-year payout limitation under the first permissible delay rule does not apply to this rule.[112]

The following variation on Example 11 illustrates the second permissible delay rule. As part of the terms of the stock sale, the shareholders and buyer agree that 20% of the purchase price is subject to an earn-out based on achievement of financial goals in calendar years 2 through 7 after the sale. The financial goals satisfy the requirements for a substantial risk of forfeiture. The buyer will make the earn-out payments to the shareholders by March 15 after each calendar year that the financial goals for that year are achieved.

Before and in connection with the stock sale, the employer, employee, and buyer agree that 20% of the employee's deal bonus will be subject to the earn-out, and will be paid on the same schedule and under the same terms and conditions as apply to the shareholders generally. The balance of the deal bonus will be paid in a lump sum within 30 days after closing in accordance with the original terms of the bonus. The

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[107] One commentator takes the position that regardless of whether the good reason event satisfies the definition of a voluntary separation from service for good reason under Treas. Reg. §1.409A-1(n)(2), as long as the good reason event otherwise creates a substantial risk of forfeiture under Treas. Reg. §1.409A-1(d), it should be a permissible vesting event. Schohn, ''Short-Term Deferrals,'' in *Section 409A Handbook* 6-1, 24–25.

[108] Reg. §1.409A-3(i)(5)(iv)(A).

[109] *Id.*

[110] *Id.*

[111] *Id.*

[112] *Id.*

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20% of the employee's deal bonus will be a short-term deferral.

ACCELERATION OF PAYMENTS ON A CHANGE-IN-CONTROL

When the original bonus arrangement does not provide for payment on a §409A-compliant change-in-control event, and the employer wishes to accelerate payment on this event, it has to rely on the exception to the anti-acceleration rules for plan terminations and liquidations. This exception permits acceleration in three situations, one of which is a §409A-compliant change-in-control event.[113] The other two situations are: (1) termination and liquidation of all similar aggregated deferred compensation plans;[114] and (2) termination and liquidation of a deferred compensation plan on a corporate dissolution taxed under §331, or with the approval of a U.S. bankruptcy court.[115]

The exception for plan terminations and liquidations is one of 13 exceptions to the anti-acceleration rules.[116] For all the exceptions, a plan can provide for acceleration of payment in accordance with the §409A regulations, or provide the employer with the discretion to accelerate payment in accordance with the §409A regulations. The §409A regulations do not require that the plan provide for the exception in writing.[117] As long as the exception's requirements are met, neither the accelerated payment, nor the addition of a provision permitting the accelerated payment, will be an impermissible acceleration. In addition, neither the failure to make the accelerated payment, nor the deletion or modification of a provision permitting the accelerated payment, will trigger the subsequent deferral election rules.[118]

In addition, all the exceptions are subject to a prohibition on employee discretion to accelerate a payment.[119] A plan cannot grant an employee this discretion, and an employer cannot provide an employee with a direct or indirect election as to whether the employer can exercise its discretion to accelerate a payment. Whether an employer provides an employee with this election is based on all the facts and circumstances, including whether similarly situated employees have been treated differently.[120]

The prohibition on an employee election becomes a thorny issue if a bonus arrangement requires the employer to obtain the employee's consent to termination and liquidation of the arrangement, or to any other arrangement aggregated with it. It also becomes an issue if any of the aggregated arrangements is silent on termination and liquidation, and under the common law of contracts the employer must obtain the employee's consent and give the employee additional consideration for this consent.[121] In these situations, tax counsel should assess the likelihood of IRS success in asserting that the employee's consent is tantamount to providing the employee with an impermissible direct or indirect election as to whether the employer can exercise its discretion to accelerate a payment.[122]

One way to address this issue is for the employer to prophylactically provide in every bonus arrangement subject to §409A that the employer has the exclusive authority and discretion to terminate and liquidate the arrangement and all other arrangements aggregated with it under any of the exceptions to the anti-acceleration rules and without the consent of any participant or beneficiary.

The four requirements for acceleration of payments on a §409A-compliant change-in-control are:

(1) The employer terminates and liquidates the plan pursuant to irrevocable action within 30 days before or 12 months after a §409A-compliant change-in-control event;

(2) The employer terminates and liquidates all plans sponsored by it immediately after the change-in-control event that are treated as a single plan under Reg. §1.409A-1(c)(2) with respect to each

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[113] Reg. §1.409A-3(j)(4)(ix)(B).

[114] Reg. §1.409A-3(j)(4)(ix)(C). Prop. Reg. §1.409A-3(j)(4)(ix)(C)(2), Prop. Reg. §1.409A-3(j)(4)(ix)(C)(5). In the Preamble to the proposed amendments, the IRS states that the meaning of the current regulation is unambiguous, and the amendments "further clarify that the acceleration of a payment pursuant to this rule is permitted only if the service recipient terminates and liquidates all plans of the same category that the service recipient sponsors and not merely all plans of the same category in which a particular service provider actually participates. These proposed regulations also clarify that under this rule, for a period of three years following the termination and liquidation of a plan, the service recipient cannot adopt a new plan of the same category as the terminated and liquidated plan, regardless of which service providers participate in the plan." 81 Fed. Reg. at 40,575.

[115] Reg. §1.409A-3(j)(4)(ix)(A).

[116] §409A(a)(3); Reg. §1.409A-3(j)(4).

[117] Reg. §1.409A-1(c)(3)(iv), §1.409A-3(j)(4)(i).

[118] Reg. §1.409A-3(j)(4)(i).

[119] *Id.*

[120] *Id.*

[121] *See, e.g., Best Buy Builders, Inc. v. Siegel*, 409 S.W.3d 562, 565 (Mo. Ct. App. 2013) (when the parties modify an existing contract, they are making a new contract; the new contract is enforceable only if there is mutual assent and consideration).

[122] *See* Daniel L. Hogans, "Mergers and Other Corporate Transactions," in *Section 409A Handbook* 17-1 (the exception for plan terminations and liquidations on a change-in-control could be available if due to the failure to obtain the consent of even one participant the plan would not be terminated for any participant, or if the employer is seeking consent only as a protective measure and the plan would be terminated for all participants in any event).

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participant who experienced the change-in-control event;

(3) All participants receive all amounts of compensation deferred under the terminated plans within 12 months after the date that the employer irrevocably takes all necessary action to terminate and liquidate the plans; and

(4) Solely for purposes of this exception, the employer with the discretion to liquidate and terminate the plans is the employer that is primarily liable immediately after the transaction to pay the deferred compensation.[123]

Under the fourth requirement, determining the employer that is primarily liable immediately after the transaction to pay the deferred compensation is the critical task. For example, when the change-in-control event is the sale of stock of a subsidiary corporation and the subsidiary is no longer treated as a single employer with the former parent corporation, the plan termination and liquidation requirement applies to the post-transaction buyer controlled-group of corporations that includes the subsidiary corporation.[124] Moreover, the plan termination and liquidation requirement applies only to the plans maintained for the participants that experienced the change-in-control. These participants are the subsidiary's employees.

When the change-in-control event is an asset purchase, the plan termination and liquidation requirement applies to the entity with the liability to pay the deferred compensation after the purchase.[125]

One commentator points out that if the change-in-control event is a stock sale and the plans are maintained at the parent level, the employer primarily liable immediately after the transaction for payment of the deferred compensation would be the parent, and not the buyer. If the change-in-control event is a merger or stock sale of the employer that sponsors the plan, the employer primarily liable immediately after the transaction to pay the deferred compensation is the resulting corporation or buyer. If the employees that experienced the change-in-control who participated in the sponsoring employer's plan or plans before the transaction begin to participate in a similar plan or plans of the resulting corporation or buyer after closing, the requirement to terminate and liquidate with plans as to these employees applies to the plans of the sponsoring employer before closing and the plans of the resulting corporation or buyer after closing.[126]

Under these rules, it is important that the plans in which the employees experiencing the change-in-control participate be terminated before these employees participate in the acquiror's plans. Otherwise, the acquiror's plans would need to be terminated as to these employees. One way to avoid the need to terminate the acquiror's plans is for the seller to terminate its plans in the 30-day window before the change-in-control, with the termination contingent and effective on closing of the change-in-control.

The exception for plan terminations and liquidations also raises the issue of whether after the change-in-control the employer can permit the employees who experienced the change-in-control to participate in a plan was not required to be terminated and liquidated, but otherwise would have been aggregated with any terminated and liquidated plan. The regulations do not expressly prohibit this participation.

Furthermore, in the second situation of termination and liquidation of all similar deferred compensation plans subject to aggregation, the regulations expressly prohibit the employer from adopting a new plan that would be aggregated with any terminated and liquidated plan within three years after the date that the employer takes all necessary action to irrevocably terminate and liquidate the plan.[127]

Tax counsel can take the position that because the regulations do not expressly prohibit adoption of a new plan after termination and liquidation of a plan on a change-in-control, but do after termination and liquidation of all similar plans, the regulations permit the employer to adopt a new plan or permit participation in an existing plan after termination and liquidation of a plan on a change-in-control.

Accordingly, participants in the terminated plans can, immediately after termination of the plans, participate in similar plans that the employer maintains for employees who did not experience the change-in-control. Because the §409A regulations do not require termination of the similar plans, these participants can participate in the similar plans.[128] For example, Company A buys all the stock of Company T. As a result, Company T has a change-in-control, but Company A does not. Immediately after the transaction, Company A terminates all of Company T's elective account balance plans for legacy Company T employees. Exist-

[123] Reg. §1.409A-3(j)(4)(ix)(B).

[124] §VIII.B., 72 Fed. Reg. 19,234, 19,267 (Apr. 17, 2007).

[125] *Id.*

[126] Susan A. Wetzel, *A Practitioner's Guide to Addressing Code Section 409A Issues in Mergers and Acquisitions*, 35 *Texas Tax Lawyer* 2, 7 (May 2008).

[127] Reg. §1.409A-3(j)(4)(ix)(C)(5); Prop. Reg. §1.409A-3(j)(4)(ix)(C)(5).

[128] Daniel L. Hogans, ''Mergers and Other Corporate Transactions,'' in *Section 409A Handbook* 17-1, 12-.

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ing Company A plans of the same type are unaffected by the termination of Company T plans. Company A may permit legacy Company T employees to participate in Company A elective account balance plans without delay after the termination of the legacy Company T plans.[129]

SUBSEQUENT DEFERRAL ELECTIONS

A subsequent deferral election must satisfy the following three requirements:

(1) The plan requires that the election will not take effect until at least 12 months after the date on which the election is made;

(2) For a payment made at a specified time or pursuant to a fixed schedule, on separation from service, or on a §409A-compliant change-in-control, the plan requires that the payment be deferred for at least five years from the date that it otherwise would have been paid. For a life annuity or installment payments treated as a single payment, the plan requires that the payment be deferred for at least five years from the date of the first scheduled payment. The five year deferral requirement does not apply to any payment made on death, disability, or unforeseeable emergency; and

(3) The plan requires that any election for a payment at a specified date or pursuant to a fixed schedule be made at least 12 months before the date of the first scheduled payment. For a life annuity or installment payments treated as a single payment, the plan requires that the election be made at least 12 months before the date of the first scheduled payment.[130]

A payment means each separately identified amount to which an employee is entitled to payment on a determinable date, and includes amounts applied for the employee's benefit.[131] An amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula.[132] For example, an amount identified as 10% of the account balance as of a specified payment date is a separately identified amount.[133] The entitlement to a series of installment payments is treated as the entitlement to 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.[134]

For an arrangement that permits a payment on more than one payment event, such as the earlier of a fixed date and separation from service, the requirements for subsequent deferral elections are applied separately to each payment on each payment event.[135]

In addition, for the employer to make a subsequent deferral election, the original arrangement would had to have given the employer the discretion to make the election, or permitted the employee to consent to the employer's election. Otherwise, at the time of the subsequent deferral election the employee would have to consent to the employer's election. Under the common law of contracts the employer would have to give the employee additional consideration for the consent.[136]

Similarly, for the employee to make a subsequent deferral election, the original arrangement would had to have given the employee the discretion to make the election, or permitted the employer to consent to the employee's election. Otherwise, at the time of the subsequent deferral election the employer would have to consent to the employee's election. Under the common law of contracts the employee would have to give the employer additional consideration for the consent.[137]

Applying these rules to Example 10 produces the following results.[138] When the installment payments on September 1, 2018, 2019, and 2020, are treated as a single payment commencing on September 1, 2018, a subsequent deferral election for any of the installments is unavailable. Because the employer awarded the bonus on July 1, 2018, two requirements for a subsequent deferral election are not met. First, the requirement that the election not take effect for at least 12 months after the date on which the election is made is not met. Second, the requirement that any election for a payment at a specified date or pursuant

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[129] *Id.* at *Ex. 1*.

[130] §409A(a)(4)(C); Reg. §1.409A-2(b)(1).

[131] Reg. §1.409A-1(b)(4)(i)(F), §1.409A-2(b)(2)(i). Proposed amendments to the §409A regulations provide a rule to determine whether a payment has occurred under all the §409A regulations. Prop. Reg. §1.409A-1(q).

[132] Reg. §1.409A-2(b)(2)(i).

[133] *Id.*

[134] Reg. §1.409A-2(b)(2)(iii).

[135] Reg. §1.409A-2(b)(6).

[136] *See, e.g., Best Buy Builders, Inc. v. Siegel*, 409 S.W.3d 562, 565 (Mo. Ct. App. 2013) (when the parties modify an existing contract, they are making a new contract; the new contract is enforceable only if there is mutual assent and consideration).

[137] *Id.*

[138] The discussion of the alternatives under Example 10 has the employee make a subsequent deferral election. The same analysis applies if the arrangement gives the employer the right to make a subsequent deferral election.

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to a fixed schedule be made at least 12 months before the date of the first scheduled payment is not met.

If the employer determined on July 1, 2018, to pay the installments on September 1, 2019, 2020, and 2021, and the installments are treated as a single payment, the following subsequent deferral elections are available. The employee can elect on or before September 1, 2018, to defer each installment for five or more years with the first installment commencing on or after September 1, 2024, and if earlier in a lump sum equal to the unpaid installments on the date of a §409A-compliant change-in-control.

Alternatively, if the employee wishes to convert the installment payments to a single lump-sum payment, the employee can elect on or before September 1, 2018, to receive a lump-sum payment of the total amount on or after September 1, 2024, the date that is five years after the first installment payment date of September 1, 2019, and if earlier in a lump sum on the date of a §409A-compliant change-in-control.[139]

As another alternative, the employee can elect on or before September 1, 2018, to defer the installments to a series of 10 equal annual installments commencing on or after September 1, 2024, the date that is five years after the first installment payment date of September 1, 2019, and if earlier in a lump sum equal to the unpaid installments on the date of a §409A-compliant change-in-control.

When the installment payments are paid on September 1, 2018, 2019, and 2020, and are designated as a series of separate payments, the following subsequent deferral elections are available. The employee can elect on or before September 1, 2018, to defer: (1) the September 1, 2019, installment to on or after September 1, 2024, and if earlier in a lump sum equal to the sum of the unpaid September 1, 2019, and 2020, installments on the date of a §409A-compliant change-in-control; and (2) the September 1, 2020, installment to on or after September 1, 2025, and if earlier in a lump sum on the date of a §409A-compliant change-in-control.

Alternatively, the employee can elect on or before September 1, 2018, to defer only the September 1, 2019, installment and have the September 1, 2020, installment continue to be paid on that date, and if earlier in a lump sum equal to the sum of the unpaid September 1, 2019, and 2020, installments on the date of a §409A-compliant change-in-control. In addition, on or before September 1, 2019, the employee can elect to defer the September 1, 2020, installment to on or after September 1, 2025, and if earlier the date of a §409A-compliant change-in-control.[140]

When the installment payments are designated as a series of separate payments, and the employee wishes to convert the installment payments to a single lump-sum payment, the employee can elect on or before September 1, 2018, to have the total of the September 1, 2019, and 2020, installments paid on or after September 1, 2025, the date that is five years after the last installment payment date of September 1, 2020, and if earlier in a lump sum on the date of a §409A-compliant change-in-control.[141]

To protect the ability of the employer and employee to make subsequent deferral elections for the separate installment payments, every bonus arrangement should contain a separate payment clause that prophylactically provides for purposes of §409A: (1) each separately identified amount is designated as a separate payment; and (2) any series of installment payments is designated as a right to a series of separate payments, and not one of a series of payments treated as a single payment.[142]

ADDITION OF CHANGE-IN-CONTROL AS A NEW PAYMENT EVENT

In Example 10, had the original bonus arrangement not provided for payment on a §409A-compliant change-in-control event, the anti-acceleration rules would have prohibited the employer or employee from adding a change-in-control event as an earlier payment date than the originally scheduled payment dates.[143] Furthermore, the addition or substitution of a permissible payment event to an existing deferral is subject to the subsequent deferral election rules if the

[139] *See* Reg. §1.409A-2(b)(9) *Ex.* 19.

[140] *See* Reg. §1.409A-2(b)(9) *Ex.* 18.

[141] Reg. §1.409A-2(b)(9) *Ex.* 20.

[142] For the use of a separate payment clause to protect the availability of the short-term deferral exemption for installment payments paid in the applicable 2½ month period, see above nn. 33–35 and accompanying text.

[143] Reg. §1.409A-2(b)(9), *Ex.* 24, §1.409A-3(j)(2). The §409A regulations permit the addition of employee's death, disability (as defined in Reg. §1.409A-3(i)(4)), or unforeseeable emergency (as defined in Reg. §1.409A-3(i)(3)), as a potentially accelerated payment event. Reg. §1.409A-3(j)(2). Proposed amendments to the §409A regulations extend the right to accelerate on the death, disability, or unforeseeable emergency of the employee's beneficiary who has become entitled to payment due to the employee's death. The proposed amendments also provide that a schedule of payments (including payments treated as a single payment) that has already commenced before an employee's or beneficiary's death, disability, or unforeseeable emergency can be accelerated on these events. Prop. Reg. §1.409A-3(j)(1)–(2). Accordingly, the plan can permit the employer at any time, or the employee or his or her beneficiary at any time, to elect to have payment made on one or more of these events if they occur before the designated payment date. The change will be immediately effective.

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addition or substitution may result in a change in the time or form of payment.[144] Accordingly, when adding or substituting a new payment event, the change must not be effective for one year, and the change must provide for payment on the later of the new payment event, and five years after the original payment date.

Applying these rules to Example 10 produces the following results. When the installment payments on September 1, 2018, 2019, and 2020, are treated as a single payment commencing on September 1, 2018, a subsequent deferral election is unavailable. Because the employer awarded the bonus on July 1, 2018, two requirements for a subsequent deferral election are not met. First, the requirement that the election not take effect for at least 12 months after the date on which the election is made is not met. Second, the requirement that any election for a payment at a specified date or pursuant to a fixed schedule be made at least 12 months before the date of the first scheduled payment is not met.[145]

Had the employer determined on July 1, 2018, to pay the installments on September 1, 2019, 2020, and 2021, and the installments are treated as a single payment, the employee can elect to convert all the installment payments to a single lump sum payable on the later of five years after the initial installment was originally to be paid, and the date of a §409A-compliant change-in-control. The employee can elect on or before September 1, 2018, to have the total amount of the September 1, 2019, September 1, 2020, and September 1, 2021, installments paid on the later of September 1, 2024, and the date of a §409A-compliant change-in-control.[146]

When the installment payments on September 1, 2018, 2019, and 2020, are designated as a series of separate payments, the following subsequent deferral elections are available. The employee can elect on or before September 1, 2018, to defer: (1) the September 1, 2019, installment to the later of September 1, 2024, and the date of a §409A-compliant change-in-control; and (2) the September 1, 2020, installment to the later of September 1, 2025, and the date of a §409A-compliant change-in-control. In addition, the employee can elect on or before September 1, 2019, to defer the September 1, 2020, installment to the later of September 1, 2025, and the date of a §409A-compliant change-in-control.[147]

When the installment payments are designated as a series of separate payments, and the employee wishes to convert the installment payments to a lump sum, the employee can elect on or before September 1, 2018, to have the total amount of the September 1, 2019, and September 1, 2020, installments paid on the later of September 1, 2025, and the date of a §409A-compliant change-in-control.[148]

BONUS AWARDED AS PERFORMANCE-BASED COMPENSATION

Section 409A and the §409A regulations provide a separate initial deferral election for performance-based compensation.[149] In addition, depending on the terms of the arrangement, performance-based compensation can be a discretionary or nondiscretionary arrangement, a short-term deferral, or a plan of deferred compensation. As a result, other initial deferral elections can apply, such as the general rule and the elections for a short-term deferral, first year of eligibility to participate, and the employer election.

Performance-based compensation means compensation for which the amount, or the entitlement to, is contingent on the satisfaction of pre-established organizational or individual performance criteria for a performance period of at least 12 consecutive months. Criteria are pre-established if they are established in writing by no later than 90 days after the commencement of the period of service to which the criteria relate, but only if the outcome is substantially uncertain when they are established.[150]

Performance-based compensation includes payments based on subjective performance criteria, but only if the criteria are bona fide and relate to the performance of the employee, a group of employees that includes the employee, or a business unit for which the employee provides services (which may include the entire organization).[151] The use of subjective performance criteria will likely make the bonus discretionary.

Accordingly, vesting conditions based on length of service are impermissible performance criteria. In addition, the rules do not require that the performance

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The rule that permits the addition of these events as an earlier payment event does not permit their addition as a potentially later payment event. For example, if an arrangement provides for payment on a specified date, the addition of death as a payment event so that payment is made on the later of the specified date and death is impermissible. Furthermore, the rule does not permit the substitution of these events for a specified date as a new payment event. In these situations, the subsequent deferral election rules apply.

[144] Reg. §1.409A-2(b)(6).

[145] *See* Reg. §1.409A-2(b)(9) *Ex.* 19.

[146] *See* Reg. §1.409A-2(b)(9) *Exs.* 19, 24.

[147] *See* Reg. §1.409A-2(b)(9) *Exs.* 18, 22–24.

[148] Reg. §1.409A-2(b)(9) *Ex.* 20.

[149] §409A(a)(4)(B)(iii); Reg. §1.409A-1(e), §1.409A-2(a)(8).

[150] Reg. §1.409A-1(e)(1).

[151] Reg. §1.409A-1(e)(2)(i).

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criteria be approved by the employer's board of directors, compensation committee, or shareholders.[152] However, tax counsel should determine whether board, compensation committee, or shareholder approval is necessary under any plan documents, corporate governance documents, exchange-listing rules, or state law.

Compensation qualifies as performance-based compensation if the employer also pays the compensation on the employee's death, disability, or a change-in-control event (as defined in Reg.§1.409A-3(i)(5)(i)) regardless of satisfaction of the performance criteria.[153] However, a payment made on any of these events is not performance-based compensation.[154] As a result, an initial deferral election made under the performance-based compensation rules will not apply to that payment.

Under the performance-based compensation rules, an employee must make an initial deferral election on or before the date that is six months before the end of the performance period. In addition, the employee must perform services continuously from the later of the beginning of the performance period and the date the performance criteria are established, and through the date the employee makes the election.[155]

However, an employee cannot make an initial deferral election if the performance-based compensation has become readily ascertainable. If performance-based compensation is a specified or calculable amount, the compensation is readily ascertainable if and when the amount is first substantially certain to be paid. If the performance-based compensation is not a specified or calculable amount because the amount may vary based on the level of performance, the compensation, or any portion of the compensation, is readily ascertainable when the amount is first both calculable and substantially certain to be paid.[156]

In Example 8, on December 15, 2017, the employer establishes a bonus arrangement that provides if the average annual percentage increase in the employer's net profits from January 1, 2018, through December 31, 2020, exceeds a certain percentage, the employer will establish a bonus pool for its senior executive officers equal to the product of a certain percentage multiplied by the amount of the average annual increase in net profits. The employer will pay each officer a certain percentage of the bonus pool. In addition, the officer must be continuously employed through December 31, 2020. The employer will pay the bonus in a single lump sum between February 1 and March 15, 2021.

Under the initial deferral election for performance-based compensation, as long as the bonus has not become readily ascertainable, the employee can make an initial deferral election on or before June 30, 2020. If the arrangement also provides for payment of the bonus at target on a change-in-control (as defined in Reg.§1.409A-3(i)(5)(i)), the arrangement still qualifies as performance-based compensation. However, if a change-in-control occurs before December 31, 2020, the payment on the change-in-control does not qualify as performance-based compensation. Any initial deferral election for performance-based compensation would not be effective, and the employer would make the payment on the change-in-control, rather than on the date or event under the initial deferral election.

If the employer hires the employee on April 1, 2018, the employee cannot satisfy the requirement of performing services continuously from the later of the beginning of the performance period, January 1, 2018, and the date the performance criteria are established, December 15, 2017, and through the date that the employee makes the election on or before June 30, 2020. As a result, the employee cannot make the initial deferral election for performance-based compensation. Under the initial deferral election rules for the first year of eligibility to participate, the employee can make an initial deferral election within 30 days of April 1, 2018.[157] However, the election can apply only to the ratable portion of the bonus allocable to the employee's service after the election.[158] Had the employee been able to make the initial deferral election for performance-based compensation, the election could have applied to the entire bonus.

Under the general rule, the employee can make an initial deferral election before December 31, 2017.

Because Example 8 is also a short-term deferral, the initial deferral election for short-term deferrals also applies. Two of the requirements for this election are that it cannot take effect for at least 12 months after the date on which the employee makes the election, and that for a payment made at a specified time, the employee must make the election at least one year

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[152] Reg. §1.409A-1(e)(1).

[153] The §409A regulations use one definition of disability for disability as a permissible payment event. Reg. §1.409A-3(a)(2), §1.409A-3(i)(4). They use a different definition of disability as a permissible payment event that does not adversely affect the initial deferral election for performance-based compensation, Reg. §1.409A-1(e)(1), §1.409A-3(a)(8), and as a permissible event for cancellation of deferral elections due to disability, Reg. §1.409A-3(j)(4)(xii).

[154] Reg. §1.409A-1(e)(1).

[155] Reg. §1.409A-2(a)(8).

[156] *Id.*

[157] Reg. §1.409A-2(a)(7)(i).

[158] *Id.*

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before the first payment date.[159] Because the arrangement provides for payment between February 1 and March 15, 2021, it is necessary to determine the first payment date. Under the §409A regulations, if the specified payment date is a period in a taxable year, the date specified under the plan is treated as the first day of the period in the taxable year.[160] Therefore, the first payment date is February 1, 2021. Accordingly, the employee can make an initial deferral election on or before February 1, 2020 to defer payment to on or after February 1, 2026.

BONUS AWARDED AS A PLAN OF DEFERRED COMPENSATION AND PAYABLE ONA VESTING EVENT

Unresolved Issue: A critical, yet unresolved, issue for payment at a specified time or pursuant to a fixed schedule is whether payment on the occurrence of an event or transaction is payment on an impermissible event, or payment on a permissible vesting event.[161]

For example, can an arrangement provide for payment of a bonus to a high-level research scientist within 30 days after the date that the employer obtains FDA approval of a new drug? Must the arrangement require that the employee be employed on the date of FDA approval? Can the arrangement provide for payment if the employee has an involuntary separation from service or voluntary separation from service for good reason, and FDA approval occurs within a certain number of years after the separation from service?

As another example, can an arrangement provide for payment of a bonus of a certain percentage of the sales price of a facility, or a schedule of increasing percentages for ranges of increasing sales prices? For each arrangement, the sales price must exceed a minimum price. The same questions in the prior paragraph apply to both arrangements.

In its discussion in the Preamble to the §409A regulations of a legally binding right, the IRS recognized that the occurrence of an event or transaction can be a permissible vesting event:

> One commentator suggested that no legally binding right exists where the payment is made only upon the realization of gain from a particular investment. For example, the commentator argued that a bonus payable based upon the amount that a service provider obtains in selling property should not be treated as granting the service provider a legally binding right to the payment until the property is sold. In such a situation, however, the requirement that the property be sold is a condition to the right to the payment, but the right to the payment is still a legally binding right. The service recipient could not simply revoke the promise, sell the property, and not pay the bonus. However, the condition that the property be sold before the service provider becomes entitled to payment may constitute a substantial risk of forfeiture, depending on the specific facts and circumstances.[162]

However, in its discussion in the Preamble of the permissibility of payment schedules based on payments to the service recipient,[163] the IRS cautioned that the occurrence of a transaction is an impermissible payment event:

> [C]ommentators requested clarification whether a plan requiring an annual payment equal to a percentage of certain accounts receivable collected during the prior 12-month period would qualify as a fixed time and form of payment. The ability to schedule payments based upon the time the service recipient receives a customer's payment raises issues regarding the ability to, in effect, create an impermissible event-based payment through characterizing the payment as a schedule (for example, a payment ''schedule'' that pays an amount every year if a specified transaction occurs, which is not a permissible payment event under section 409A). In addition, these arrangements raise issues regarding the ability of the service recipient (or service provider) to control the timing of the payment of deferred compensation through an ability to influence the timing of the payment by the customer.[164]

As an example of a permissible vesting event, the §409A regulations use Example 2. In this example, a plan provides for payment of a bonus subject to the condition that the employee complete three years of service, and subject to the further condition that the requirement of continued service will lapse on the occurrence of an initial public offering, which condition if applied alone would be a substantial risk of forfeiture. The plan can provide for substantially equal payments on each of the first three anniversaries of the date that the substantial risk of forfeiture lapses, which is the earlier of three years of service and the date of an initial public offering.[165]

The analysis of whether payment on the occurrence of an event or transaction is payment on a permissible

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[159] Reg. §1.409A-2(a)(4), §1.409A-2(b)(1)-(2).

[160] Reg. §1.409A-3(d).

[161] Reg. §1.409A-3(i)(1)(i).

[162] §III.B., 72 Fed. Reg. 19,234, 19,236 (Apr. 17, 2007).

[163] Reg. §1.409A-3(i)(1)(iii).

[164] §VII.B.5., 72 Fed. Reg. 19,234, 19,257 (Apr. 17, 2007).

[165] Reg. §1.409A-3(i)(1)(i).

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vesting event begins with the definition of a vesting event: the lapse of a substantial risk of forfeiture. The two requirements for compensation to be subject to a substantial risk of forfeiture are: (1) the right to the compensation is conditioned on the performance of substantial future services by any person, or the occurrence of a condition related to a purpose of the compensation; and (2) the possibility of forfeiture is substantial.[166]

A condition related to a purpose of the compensation must relate to the employee's performance for the employer, or the employer's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value, or completion of an initial public offering).[167] In the examples, FDA approval of a drug, sale of a facility at a certain price, and completion of an initial public offering are all occurrences of a condition related to the employer's business activities or organizational goals.

The second requirement for a vesting event is whether the possibility of forfeiture is substantial. Other than for an employee who owns a significant amount of the total combined voting power or value of the employer's equity, the §409A regulations do not provide guidance on whether the possibility of forfeiture is substantial. [168] Moreover, the amoeba-like amorphousness of this requirement gives the IRS broad discretion to challenge an employer's or employee's determination that the occurrence of an event or transaction creates a substantial possibility of forfeiture.[169] Accordingly, there is a pressing need for meaningful guidance that enables the employer and employee to determine with reasonable certainty whether their arrangement satisfies the second requirement.

Author Proposes Two-Prong Test: To provide meaningful guidance, the author of this article recommends a two-pronged test for whether the possibility of forfeiture is substantial. The first prong is the absence of a substantial degree of control by the employee over the employer and the timing of the event or transaction. The second prong is that at the time the parties enter into the arrangement the compensation from the event or transaction is not readily ascertainable.

For the first prong of substantial control, the §409A regulations currently focus on control over the timing of the payment. One of the requirements for a permissible payment schedule in which the amount of a payment or payments is paid at a specified time or during a specified period, and that is limited by an objective nondiscretionary formula or a specified amount, is that the schedule is not under the employee's effective control.[170]

Similarly, one of the requirements for a permissible payment schedule that provides for an aggregate amount of payments to be made during a specified period to all participants in substantially identical plans, and is limited by an objective nondiscretionary formula or a specified amount, is that the schedule is not under the employee's effective control.[171]

Furthermore, for permissible payment schedules that are determined by the timing of payments that the employer receives from customers in bona fide and routine transactions, the employee cannot have effective control of the employer, the person from whom the payments are due, or the collection of any of the amounts due to the employer.[172]

The second prong that the compensation from an event or transaction is not readily ascertainable comes from the initial deferral election for performance-based compensation.[173] Once performance-based compensation becomes readily ascertainable, an employee cannot make this initial deferral election. If performance-based compensation is a specified or calculable amount, the compensation is readily ascertainable if and when the amount is first substantially certain to be paid. If the performance-based compensation is not a specified or calculable amount because the amount may vary based on the level of performance, the compensation, or any portion of the compensation, is readily ascertainable when the amount is first both calculable and substantially certain to be paid.[174] The purpose of the requirement that compensation be substantially uncertain to be paid is to pre-

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[166] Reg. §1.409A-1(d)(1).

[167] *Id.* The legislative history of §409A also provides that an event unrelated to the employer's business activities or organizational goals is an impermissible payment event. H.R. Rep. No. 108-755, 108th Cong., 2d Sess., at 723 (2004).

[168] Reg. §1.409A-1(d)(3)(i).

[169] *Cf.* Gregg D. Polsky, *Fixing Section 409A: Legislative and Administrative Options*, 57 Villanova Law Review 635, 645 & n. 47 (2012) (a small business owner who promises to give a loyal employee a share of the sales proceeds if and when he eventually sells his business creates a deferred compensation plan; the plan violates §409A because the eventual payment date is not a permissible distribution event; "It is possible that the sale of the company is a condition that rises to the level of a substantial risk of forfeiture, but this is by no means clear. See Treas. Reg. §1.409A-1(d)(1) (2007). If it does, then the arrangement would not violate section 409A").

[170] Reg. §1.409A-3(i)(1)(ii)(A).

[171] Reg. §1.409A-3(i)(1)(ii)(B).

[172] Reg. §1.409A-3(i)(1)(iii)(B).

[173] §409A(a)(4)(B)(iii); Reg. §1.409A-1(e); Reg. §1.409A-2(a)(8).

[174] Reg. §1.409A-2(a)(8).

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vent manipulation in the timing of income inclusion.[175]

As compensation earned on the occurrence of an event or transaction turns on attaining more difficult performance goals, the more likely it is that when the employer and employee enter into the arrangement the compensation is substantially uncertain to be paid. Accordingly, setting the appropriate performance goals is critical.

Furthermore, the requirement that compensation be substantially uncertain to be paid enables tax counsel to reconcile the potentially conflicting statements in the Preamble dealing with the occurrence of an event or transaction as an impermissible payment event or a permissible vesting event. The 2017 tax act (Pub. L. No. 115-97) repealed the performance-based compensation exception to the deduction disallowance for annual compensation of more than $1 million paid to covered employees of publicly-held corporations.[176] Before its repeal, the exception provided that performance-based compensation must be paid solely on account of the attainment of one or more pre-established, objective performance goals.[177] A performance goal was pre-established if it was established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal related, and the outcome was substantially uncertain when the compensation committee established the goal.[178]

One of the examples in the §162(m) regulations for performance-based compensation provided that Corporation S establishes a bonus plan under which A, the chief executive officer, would receive a cash bonus of $500,000 based on a percentage of Corporation S's total sales for the fiscal year. Because Corporation S was virtually certain to have some sales for the fiscal year, the outcome of the performance goal was not substantially uncertain.[179]

The Preamble to the §409A regulations states that an arrangement that provides for an annual payment equal to a percentage of certain accounts receivable collected during the prior 12-month period provides for payment on an impermissible event.[180] Tax counsel can take the position that because the employer is virtually certain to have some collection of accounts receivable, the outcome of the event is not substantially uncertain.

Accordingly, whether compensation is readily ascertainable when the parties enter into the arrangement should be part of the test of whether the possibility of forfeiture is substantial. In the examples, the compensation is conditioned on FDA approval of a drug, sale of a facility, or completion of an initial public offering. As long as the employee does not control the employer and the outcome of the event, and the compensation is not readily ascertainable when the parties enter into the arrangement, the possibility of forfeiture is substantial.

The two-pronged test is consistent with §409A's purpose to curtail an employee's ability to manipulate the timing of the receipt of compensation. The ability to manipulate turns on control. [181] When an employer engages in a transaction or sets performance goals, an employee usually lacks control over completion of the transaction or attainment of the performance goals. The employee's lack of control increases as a transaction becomes more complex, and as the attainment of a performance goal becomes more difficult. Moreover, once an employee separates from service, the employee's lack of control increases even more. Accordingly, the §409A regulations should permit payment on completion of a transaction or attainment of an employer-wide performance goal after the employee's separation from service.

After separation from service an employee can no longer attain the employee's individual performance goals. One way to address this situation is to provide for a payment on the employee's separation from service that assumes attainment of all or a portion of the employee's individual performance goals. In this manner, the payment event is the separation from service, rather than the vesting event of attainment of the individual performance goals.

Furthermore, Congress enacted §409A to address the shortcomings of the constructive receipt doctrine in preventing manipulation in the timing of the receipt of compensation. These shortcomings permitted employees to defer compensation shortly before the scheduled payment date, and to accelerate payment through haircuts and other limitations or restrictions

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[175] *See* §VI.C., 72 Fed. Reg. 19,234, 19,252 (Apr. 17, 2007).

[176] The 2017 tax act, §13601(a), repealed the performance-based compensation exception of §162(m)(4)(C). The repeal applies to taxable years beginning after Dec. 31, 2017. §13601(e)(1). A transition rule applies to compensation provided under a written binding contract that was in effect on Nov. 2, 2017, and that is not materially modified on or after that date. §13601(e)(2); Notice 2018-68.

[177] §162(m)(4)(C); Reg. §1.162-27(e)(2).

[178] Reg. §1.162-27(e)(2)(i).

[179] Reg. §1.162-27(e)(2)(vii) *Ex.* 2.

[180] §VII.B.5., 72 Fed. Reg. 19,234, 19,257 (Apr. 17, 2007).

[181] *See* H.R. Conf. Rep. No. 108-755, 108th Cong., 2d Sess., at 713 (2004); H.R. Rep. No. 108-548, 108th Cong., 2d Sess., Part 1, at 343 (2004).

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on payment.[182] Neither of these practices is at issue for payment on completion of a transaction or attainment of a performance goal. Moreover, the §409A regulations contain detailed rules on the timing of initial and subsequent deferral elections. They also contain strict anti-acceleration rules. As long these rules are satisfied, the shortcomings of the constructive receipt doctrine are addressed.

In addition, a prohibition on payment on completion of a transaction or attainment of an employer-wide performance goal that occurs after separation from service favors the employer. The prohibition bolsters the employer's leverage to use an involuntary separation from service or voluntary separation from service for good reason to deprive an employee of his or her bonus. In enacting §409A, Congress did not seek to favor the employer at the employee's expense; rather Congress sought to curtail manipulation, whether by the employer or employee acting independently or in concert.

Moreover, proposed amendments to the §409A regulations create a level playing field between the employer and employee for the employer's reimbursement of the employee's attorneys' fees and other legal expenses. The §409A regulations currently provide an exemption for the indemnification of, or the purchase of an insurance policy providing for payments of, all or part of the expenses incurred or damages paid or payable by an employee for a bona fide claim against the employee or employer. The exemption covers amounts paid or payable by the employee on the settlement of a bona fide claim against the employee or employer when the claim is based on actions or failures to act by the employee in his or her capacity as an employee of the employer.[183]

The §409A regulations also currently provide an exemption for ''amounts paid as settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, including claims under applicable Federal, state, local, or foreign laws, or for reasonable attorneys' fees or other reasonable expenses incurred by the service provider related to such bona fide legal claims, regardless of whether such settlements, awards, or reimbursement or payment of expenses pursuant to such claims are treated as compensation or wages for federal tax purposes.''[184]

The proposed amendments expand these exemptions to cover the ''payment of reasonable attorneys' fees or other reasonable expenses incurred by the service provider to enforce any bona fide legal claim against the service recipient with respect to the service relationship between the service provider and the service recipient.''[185] Under the expanded exemption, the employer cannot use noncompliance with §409A as leverage against an employee who has negotiated for reimbursement of the employee's attorneys' fees in litigation between the employer and employee.

Accordingly, the §409A regulations should permit an event or transaction that satisfies the two-pronged test of this article to be a permissible vesting event regardless of whether that event or transaction occurs before or after an involuntary separation from service or voluntary separation from service for good reason, or a separation from service due to death, disability, or retirement.

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[182] For the timing of deferral elections under the constructive receipt doctrine, *see* n. 8, above.

[183] Reg. §1.409A-1(b)(10).

[184] Reg. §1.409A-1(b)(11).

[185] Prop. Reg. §1.409A-1(b)(11).

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