

Upsetting the Apple Cart: New Deferred Compensation Rules Endanger Employment Agreements and Severance Plans

By: Timothy G. Verrall

Morrison & Foerster LLP

It has been said that the one law Congress *always* passes is the “Law of Unintended Consequences,” and Section 409A of the Internal Revenue Code (“Code”), adopted as part of the American Jobs Creation Act of 2004, certainly proves the point. Even if you’ve heard of Section 409A, you may well be asking yourself: “Why should I care about it? It only applies to those high-dollar deferred compensation plans that corporate bigwigs have, right? We don’t do any of that kind of thing around here.” Not. So. Fast.

To be sure, Section 409A covers those sorts of plans, but its reach can extend to such common and seemingly-innocuous arrangements as bonus programs, severance pay plans, and employment and consulting agreements. Violating Teddy Roosevelt’s famous dictum, Section 409A doesn’t walk very softly, but it does carry a big stick: violate its requirements, and the affected employees will be hit with an additional 20% tax in addition to the income tax they will also owe...and probably coming back to you in search of a gross-up to cover their unexpected tax liability.

While Section 409A’s arm is long, it does have its limits. This *Commentary* explores those limits in the context of common employee arrangements like employment and consulting agreements, bonus and incentive compensation programs, equity compensation arrangements, severance programs, and “change in control” agreements and arrangements, and offers some suggestions for staying out of the Section 409A doghouse. Read on – your employees will thank you.

1. Background.

Following Enron’s collapse, Congress’ long-dormant interest in regulating the operation of deferred compensation arrangements began to reawaken.¹ The possibility that executives would remain able to leap from the helm with golden parachutes firmly in hand as their financially-troubled companies veered towards the shoals of bankruptcy ultimately proved an irresistible target: after several years of consideration, Congress finally enacted Section 409A, imposing greater limitations on the ability of participants in deferred compensation arrangements to manipulate the timing of elections to defer current compensation, the form and timing of subsequent payments of deferred compensation, and their ability to make changes to these elections after the fact.² The

¹ Prior to the enactment of Section 409A, Congress’ last serious consideration of deferred compensation arrangements appeared in the Revenue Act of 1978 and consisted of a blanket prohibition on the IRS’s issuance of further regulatory guidance in the area.

² Refer to our prior *Client Alerts* entitled “Deferred Compensation Plans To Undergo Major Changes Under American Jobs Creation Act of 2004” ([link](#)); “Deferred Compensation Update: IRS Issues Initial Guidance Notice 2005-1” ([link](#)); and “Deferred Compensation Update: IRS Issues Proposed Regulations under Code Section 409A” ([link](#)) for a more detailed and technical discussion of Section 409A’s requirements.

“muscle” behind these new requirements is an additional 20% tax that is imposed on employees and contractors who receive payments that violate Section 409A.

Supplementing Section 409A’s relatively sparse statutory language, the IRS has recently issued lengthy proposed regulations that flesh out the new requirements and provide a number of useful escape routes, as discussed in more detail below. First, however, a consideration of some key Section 409A definitions is in order.

2. Key Definitions.

A 20% penalty can serve as a strong incentive for creativity in designing deferred compensation arrangements. Recognizing the possibility for abuse that can come from such creativity, the IRS took considerable care in defining the terms that set Section 409A’s boundaries in order to block obvious means of avoiding its application.

- Service Recipient: An employer or other person or entity who receives services rendered by a “service provider.”
- Service Provider: An employee or independent contractor who performs the services that give rise to the right to receive the deferred compensation.
- Nonqualified Deferred Compensation Plan: A “plan” providing for the “deferral of compensation.” This definition can include formal plans, individual agreements with employees or contractors, and less formal arrangements that have the effect of deferring compensation from one tax year to another. Employment agreements, bonus programs, severance plans, and other common arrangements all potentially fall within this definition.
 - Important Exclusions: A number of broad-based plans subject to substantial other regulations are excluded from this definition³ as are bona fide vacation, sick, and compensatory time-off programs, disability pay arrangements, and death benefit plans. In addition, Archer medical savings accounts, health savings accounts, health reimbursement accounts, and other medical expense reimbursement programs that satisfy the requirements of Code Sections 105 and 106 are also excluded.
 - Deferral of Compensation: In simple terms, “plan” provides for the “deferral of compensation” if it permits an employee or contractor to voluntarily elect to defer the receipt of compensation that would otherwise be payable *now* until a point (or points) in *later* tax year.

³ This definition excludes tax-qualified retirement plans (*e.g.*, 401(k) plans, profit sharing plans, ESOPs, and defined benefit pension plans), Section 403(b) tax-sheltered annuity plans, Section 457(b) “eligible” deferred compensation plans, simplified employer pension (“SEP”) and “SIMPLE” plans, and a few other less-common types of plans. Certain plans, schemes, or arrangements for individuals not working in the U.S. relating to compensation that is not subject to U.S. tax by treaty or otherwise are also excluded from this definition.

- Separation from Service: For an employee, a “separation from service” occurs at the time he or she dies, retires, or otherwise terminates employment with the employer. For a contractor, a separation from service occurs at the time the contract expires unless there is an expectation by the parties that the contract will be renewed or that the contractor will become an employee.
 - Leaves of Absence: The employment relationship continues during periods of military leave, sick leave, and other bona fide leaves of absence as long as the employee has a right of reemployment under statute or contract.
 - No Artificial Extensions of Employment Relationship: The employment relationship cannot be extended indefinitely by contract where an individual technically agrees to provide substantial services but does not actually do so. The proposed regulations include detailed rules designed to enforce this requirement.
- Key Employee/Specified Employee: Essentially interchangeable terms referring to an individual who is (1) an officer with annual compensation in excess of \$85,000 (for 2005; the amount is indexed); one of the ten employees with annual compensation greater than \$42,000 (for 2005, the amount is indexed) *and* who owns (or is treated as owning) the largest interests in the employer; or a 5% or more owner of the employer. The key employee determination is relevant to the application of the six-month delay rule discussed below.

3. Key Exceptions to Section 409A.

Under a strict reading of Section 409A, employment agreements, severance plans, bonus arrangements, and any number of other common employment practices would be subject to potentially onerous new requirements because they can cause the deferral of compensation in one way or another. Fortunately, in the proposed regulations, the IRS recognized that these practices were not in Congress’ cross-hairs and therefore created several exceptions that are of particular use in the employment context.

(a) Key Exception No. 1: Short-Term Deferrals.

In its initial Section 409A guidance, the IRS created a limited exception for deferred amounts that are paid within a relatively short period following the time when they become “vested” (*i.e.*, when the intended recipient has a legally-binding right to receive the payment). Under this exception, unless an individual is given an option to defer a payment to a later period, if the payment is actually or constructively received by the *later* of 2½ months after the end of the *first* tax year when the employee becomes entitled to receive it *or* 2½ months from the end of the year when the employee becomes entitled to receive it, the payment is *not* subject to Section 409A, regardless of its amount. We refer to this rule here as the “Short-Term Deferral Rule.”

The Short-Term Deferral Rule will be available for a payment whether or not it is “hard-wired” into an agreement as long as the payment is actually made by that deadline. The proposed regulations do include an important, if unexpectedly lenient, caveat: if a “2½ month provision” is included in an agreement, even if the payment is not made by the 2½ month deadline, as long as it is made in the same calendar year, the payment itself will not be subject to Section 409A. On the other hand, if an agreement does *not* include such an express provision and the payment is not made by the deadline (unless a limited exception is available), there will generally be an automatic Section 409A violation.

- Planning Tip: The proposed regulations recommend that employers include a “2½ month provision” in their plans to guard against inadvertent Section 409A violations if a payment is not made by the deadline. We think this is sound advice.

Although the Short-Term Deferral Rule can excuse many arrangements from Section 409A compliance, it does not except arrangements that create a legally-binding right to receive an amount from the outset.

- Example: The exception would not be available for an arrangement under which an employee has legally-binding right on day one to receive a payment in ten years, subject to a substantial risk of forfeiture for the first three years (*e.g.*, a requirement that his employment continue uninterrupted for three years), if the payment is actually made after the risk of forfeiture lapses at the end of year three, *even if the payment is made within 2½ months after the end of year three.*
 - Problem for Constructive Discharge/“Good Reason” Provisions: As discussed below, many common constructive discharge or “termination for good reason” provisions in employment agreements do not, in the IRS’s view, constitute substantial risks of forfeiture. The consequence of this is that amounts that may become payable upon termination for good reason are likely to be regarded as vested, therefore rendering the Short-Term Deferral Rule unavailable and Section 409A applicable.
 - Practical Application—Bonus Arrangements: Under a typical bonus arrangement, bonuses do not become payable until an employer’s board of directors (or other authority) determines that the relevant performance goals were satisfied and specifies a time for payment. Employees subject to such an arrangement would not become vested in their bonuses for Section 409A purposes until the board approves their payment. By structuring its bonus program to provide for payments to be made by the deadline specified by the Short-Term Deferral Rule, an employer can avoid Section 409A coverage.
- (b) Key Exception No. 2: Severance Pay Plans.

In its initial Section 409A guidance, the IRS created two categories of severance pay plans that were exempt from coverage: plans that are maintained pursuant to a collective bargaining agreement and those that cover no “key employees.” Given the narrow scope of these two exceptions, it initially appeared that most severance plans would be required to comply with Section 409A. While most severance plans can be conformed to Section 409A’s requirements without great difficulty, no employers welcomed this additional compliance challenge. While the IRS clearly views severance programs as a potential enforcement trouble-spot,⁴ in response to various comments received during 2005, it did include a number of more useful exceptions for severance plans in the proposed regulations.

(i) Negotiated Severance Pay. The proposed regulations draw a distinction between preexisting severance plans and severance arrangements that are the product of arm’s-length negotiations in connection with an involuntary termination of employment. For the latter type of arrangement, the proposed regulations indicate that any elections as to the form and timing of severance payments will not be deemed to be made until the date on which the employee has a legally-binding right to the payment. As a practical matter, this approach allows a significant amount of flexibility in negotiating when and how severance payments will be made. However, if the amount and timing of the severance pay and other benefits at issue do not fit into the exception for broad-based severance plans discussed below, the separation agreement under which they are paid could be subject to Section 409A. In this event, payments under the separation agreement should be conformed to Section 409A’s requirements.

- Example: SubCo determines that employee Smith has overstayed his welcome and desires to terminate Smith’s employment in an expeditious and discrete manner. To facilitate the termination, SubCo proposes to pay Smith \$10,000 in severance pay in exchange for a general release of all claims to be executed by Smith; by its terms, Smith’s release will not become effective for seven days after it is executed. Because Smith’s severance pay is less than two times his annual compensation and will be paid in a lump sum shortly after this termination, this severance pay agreement will not be subject to Section 409A.

(ii) Broader-Based Severance Plans. The proposed regulations include another exception for severance plans that (1) limit individual benefits to the lesser of twice an employee’s annual compensation or two times the limit in effect under Code Section 401(a)(17) for the immediately-preceding calendar year;⁵ and (2) require all payments to be completed by the end of the second calendar year following the year of termination.

⁴ The IRS notes in the preamble to the proposed regulations that there is no substantive distinction between a severance pay plan and a deferred compensation arrangement that pays benefits upon a termination of employment.

⁵ Code Section 401(a)(17) limits the amount of annual compensation that can be taken into account for various purposes under tax-qualified retirement plans. For 2006, this limit is \$215,000; this limit is indexed for inflation.

- Example: SubCo maintains a severance plan that is available to employees who are selected for termination in connection with reductions in force. The plan caps severance pay at the lesser of two times annual compensation or \$430,000 (or any higher indexed limit under Code Section 401(a)(17) and provides for lump sum payments to be made as soon as administratively practicable following the date on which employees' releases become effective. The plan is not subject to Section 409A.⁶

(iii) Window Programs: The proposed regulations define a "window" severance plan as an arrangement that provides for separation pay for a voluntary termination within a specified and limited period of time (*i.e.*, one year or less). Although terminations made in connection with a window severance program are technically voluntary (and would therefore be subject to Section 409A absent the regulatory exception), the proposed regulations except them from Section 409A coverage to the same extent as broader-based severance plans.

- Example: SubCo adopts a window severance plan to encourage certain of its employees to voluntarily retire. The plan provides various retirement incentives, but the total value of the incentives is capped at the lesser of two times annual compensation or \$430,000 (or any higher indexed limit under Code Section 401(a)(17)). Payments are to be completed within twenty-four months following termination. Even though electing employees will voluntarily terminate employment, Section 409A will not be applicable
- Potential Issue: The window plan exception will place greater importance on correctly valuing early retirement incentives such as pension "sweeteners" and enhanced retiree health care benefits. Exceeding the compensation cap will result in loss of the exception and Section 409A coverage.

The proposed regulations also address a fairly obvious end-run in the window plan context. If, based on the relevant facts and circumstances, an employer has a pattern of providing substantially similar window arrangements for substantially consecutive limited periods of time, the window plan exception will not be available and Section 409A will be applicable.

(iv) Constructive Discharge/"Good Reason" Terminations. Severance benefits payable only upon involuntary termination are regarded as non-vested rights because they are subject to a substantial risk of forfeiture that is objectively determinable.

⁶ Under regulations issued by the Department of Labor under ERISA, many severance plans already include provisions similar to those included in the proposed regulations. Under the ERISA regulations, a severance plan under which no payments are contingent on an employee's retirement, all payments are completed with twenty-four months after termination, and no payments exceed two times an employee's annual compensation is deemed to be an "employee welfare benefit plan," thereby avoiding classification as an "employee pension benefit plan" with its attendant difficulties.

As discussed above, the IRS is skeptical of severance benefits that may be payable upon constructive discharge or terminations for “good reason”: although these provisions are nominally equivalent to involuntary termination provisions, many of them contain fairly subjective justifications for termination, some of which may be left to the discretion of the employee at issue. The preamble to the proposed regulations indicates that such terminations require factual analysis to determine whether the rights at issue are vested. While the possibility that a “good reason” provision will create a substantial risk of forfeiture is not categorically rejected by the proposed regulations, neither do they create a safe harbor for these provisions.⁷

- Example: SubCo’s change in control severance plan permits an employee to voluntarily terminate his or her employment within one year following a change in control if the successor company (1) materially reduces the employee’s base salary or incentive compensation; (2) requires the employee to work from a location that is more than 25 miles from his pre-change work location; or (3) materially diminishes, in the employee’s reasonable determination, in the employee’s position, status or circumstance of employment or the assignment to the employee of any duties or responsibilities which result in any material diminution or adverse change in the employee’s position, status or circumstances of employment. Because of the subjectivity inherent in this provision, the severance benefit will be regarded as vested from the inception of the plan, and Section 409A will be applicable. None of the severance plan exceptions will be available, and neither will the Short-Term Deferral Rule, even if the payments are otherwise made within 2½ months after the end of the year when the employee terminates his or her employment.

(v) Post-Employment Expense Reimbursements. Another common feature of employment agreements and severance plans is post-termination expense reimbursements, often for items such as COBRA premiums, outplacement services, temporary office space, and the like. The proposed regulations recognize that employers frequently agree to reimburse expenses incurred by former employees for a limited period of time after their termination.⁸ Although there is not a categorical exception for reimbursement arrangements, the proposed regulations do provide a number of more limited exceptions that should address most common situations.

⁷ At least one IRS official involved in the drafting of the proposed regulations has informally indicated his belief that *no* “good reason” provision would be sufficiently robust to avoid the application of Section 409A. While this position may be somewhat overstated, the fact remains that open-ended “good reason” provisions are unlikely to pass muster under Section 409A.

⁸ Because the promise to reimburse a former employee’s expenses is not contingent on the provision of any substantial services, the right to the payment generally would not be treated as subject to a substantial risk of forfeiture. As a result, if the period in which expenses incurred will be reimbursed extends beyond the year in which the legally binding right arises (*i.e.*, the year of termination), the right to the amount generally would constitute deferred compensation and would therefore potentially be subject to Section 409A.

(1) De Minimis Reimbursements. Post-termination reimbursements or other payments to a former employee (or contractor) that do not exceed \$5,000 in the aggregate are not subject to Section 409A. The proposed regulations do not impose any timing or substance requirements on this exception.

(2) Limited Scope Reimbursements. A limited-scope reimbursement arrangement relating to expenses that are otherwise non-taxable or that are deductible by the former employee as well as reasonable outplacement and moving expenses are not subject to Section 409A. A severance plan (voluntary or involuntary) that provides for reimbursements for medical expenses incurred and paid by the former employee but not otherwise reimbursed and not allowable as a medical expense deduction under Code Section 213(a) is also not subject to Section 409A. This exception is only applicable to reimbursements that are made on or before December 31st of the second calendar year following the year in which the former employee terminated.

For purposes of these exceptions, reimbursement arrangements include the provision of in-kind benefits, or direct payments by an employer to the person providing the goods or services to the former employee, if the provision of the in-kind benefits or direct payments would be treated as reimbursement arrangements if the former employee had paid for them and received reimbursement from the employer.

- What about COBRA Reimbursements? Employer-subsidized COBRA premiums are frequently made available to departing employees— does the exception for medical expense reimbursements apply? While the drafting of the proposed regulations leaves something to be desired on this point, it does not appear that this exception will be available because COBRA premiums are *allowable* as a deduction under Code Section 213(a). The more likely avenue for permitting COBRA subsidies without running afoul of Section 409A is referenced above in the discussion of the exclusions from the definition of the term “nonqualified deferred compensation plan.” Specially, there is an exclusion for medical expense reimbursement programs that satisfy the requirements of Code Sections 105 and 106 (relating to the excludability of employer-provided health benefits from taxable income by employees and the deductibility of these benefits by the employer, respectively) that is likely to cover many of these situations.⁹

(vi) Severance Plan Miscellany.

- The proposed regulations are clear that no Section 409A exception is available for severance pay that is, in fact,

⁹ Note that employers whose group health plans are self-funded rather than insured (*i.e.*, benefits are paid out of the employer’s general assets rather than by an insurance company) and those that provide medical reimbursements through less formal self-funded arrangements (*e.g.*, medical expense reimbursement programs) may not be able to avail themselves of this exception. Stay tuned for further regulatory developments on this point.

recharacterized deferred compensation (*e.g.*, severance pay in lieu of waived deferred compensation payments to which the employee was otherwise legally entitled).

- Severance plans that are eligible for one of the foregoing exceptions are not generally aggregated with other types of deferred compensation arrangements for purposes of Section 409A.¹⁰

(c) Key Exception No. 3: Certain Equity Compensation Programs.

Another very typical feature of employee compensation packages is equity compensation, frequently in the form of stock options and/or restricted stock and participation in employee stock purchase plans. Because Section 409A requires individuals to specify in advance the date on which their deferred compensation is to be paid, if equity compensation arrangements were to be generally subject to Section 409A, there would necessarily be a fundamental shift in their character and operations. Fortunately, many of the most common equity compensation arrangements are excluded from coverage under Section 409A. Stock option grants made at fair market value (including both incentive stock options – which must be granted at fair market value – and non-qualified stock options) are expressly excluded from Section 409A coverage. However, a stock option granted at a discount and that was not vested as of December 31, 2004 would be subject to and very likely violate Section 409A (a discounted option that must be exercised during the short-term deferral period would not be subject to Section 409A). Stock appreciation rights are given similar treatment and subjected to similar rules.

Finally, stock and other grants of property the value of which is not includible in an employee's income as a result of Code Section 83 (*i.e.*, the property is non-transferable and is subject to a substantial risk of forfeiture) or is includible solely because of a valid election under Code Section 83(b) are not regarded as deferrals of compensation. Note that if such an arrangement does permit an employee to obtain a legally-binding right to receive property (restricted or not) in a future year, it may be subject to Section 409A. The proposed regulations do provide an exception in this situation where the promise to transfer substantially non-vested property and the right to retain the substantially non-vested property after the transfer are both subject to a substantial risk of forfeiture: such an arrangement would generally constitute a short-term deferral because the payment would occur simultaneously with the vesting of the right to the property.

- Example: SubCo maintains a two-year bonus program under which an employee who continues her employment for two years will receive either an immediate cash payment of \$10,000 or a grant of restricted stock with a fair market value of \$15,000 subject to a three-year vesting schedule. The

¹⁰ The proposed regulations include aggregation rules intended to limit an employer's options for avoiding Section 409A by adopting multiple deferred compensation plans.

program could be structured to fall within the Short-Term Deferral Rule and therefore avoid the application of Section 409A.

4. Planning for the Worst.

If, despite the IRS's best efforts to excuse an employment agreement, severance plan, or other arrangement from Section 409A coverage and one of the foregoing exceptions is not available, a number of compliance issues will arise.¹¹

(a) Specified Employees/Key Employee Delay. In contrast to the usual IRS preference for deferred amounts to be taxable sooner rather than later, Section 409A imposes a requirement that mandates that deferred compensation payments made by *publicly-traded companies* to specified employees (or "key employees") be delayed for six months after their termination of employment.¹² The proposed regulations describe two approaches to implementing this delay. First, a plan may provide that the commencement of payments to a key employee due during the six-month period following his or her termination will be delayed until the end of the period. Alternatively, the plan may provide that any scheduled payment that is due during the six-month period will be delayed for six months. A combination of these two methods is permissible as well.

- Example No. 1—Payment "Starts" at Termination. Employee Williams terminates his service with SubCo on June 30, 2006 and, under the terms of the SubCo executive deferred compensation plan, becomes entitled to receive the first of 24 monthly installment payments; at the time of his termination, Williams is a key employee. The SubCo plan provides that payments to terminating key employees will technically commence upon their termination although actual payments will not be made until the first day of the seventh month following their termination of employment. On January 1, 2007, Williams will receive a combined payment including his monthly installments for the months July 2006 through January 2007; Williams will receive monthly payments beginning in February 2007 for the remaining seventeen months of his distribution period.
- Example No. 2—Payment Delayed. Employee Williams terminates his service with SubCo on June 30, 2006 and, under the terms of the SubCo executive deferred compensation plan, becomes entitled to receive the first

¹¹ Note that these issues are distinct from the larger issues that come with being required to observe Section 409A's requirements regarding deferrals of compensation (*e.g.*, the timing of deferral elections, etc.).

¹² This obvious reaction to the Enron situation might better be termed the "women and children" first rule since it attempts to make the top executives of a failing company "go down with the ship." The proposed regulations include a procedure to be used for identifying specified employees in advance. Under this procedure, an individual who is a specified employee will retain that status for rolling 12-month periods.

of 24 monthly installment payments; at the time of his termination, Williams is a key employee. The SubCo plan provides that payments to terminating key employees will not commence until the first day of the seventh month following their termination of employment. On January 1, 2007, Williams will receive his first monthly installment and will receive his remaining installments each month thereafter for the remainder of his distribution period.

Deferred compensation plans must specifically provide how they will implement the key employee delay. An employer may amend its plan to change the delay method, but such an amendment cannot become effective for at least twelve months following its adoption. A plan may permit key employees to elect how the delay will be implemented, provided these elections are made in a manner that is otherwise consistent with the deferral election rules imposed by Section 409A.

The key employee delay rule applies only to companies whose stock is publicly-traded on an established securities market. In addition, it only applies to payments made upon a key employee's separation from service. In other words, scheduled distributions, distributions tied to changes in control, unforeseeable emergencies, and other permissible distribution triggers are not subject to the delay. The proposed regulations also indicate that the rule does not apply in the case of domestic relations orders (*e.g.*, where a court compels the division of deferred compensation assets in connection with a key employee's divorce or legal separation) and mandatory conflict of interest payments under the Federal securities laws. The proposed regulations do indicate that a non-public company that contemplates a future public offering may opt include a key employee delay provision in its plan that will only become effective at the time of the public offering.

(b) Written Plan Requirement. If a plan or arrangement is subject to Section 409A, it must be memorialized in writing. Although Section 409A (the statutory provision) does not require this result, it does require the inclusion of certain provisions. The clear implication of many of Section 409A's provisions is that the plan or arrangement must be set forth in writing; the proposed regulations adopt this as a requirement. Under this regulatory requirement, a deferred compensation arrangement must be established and maintained by an employer (or other service recipient) in compliance with Section 409A, both in form and in operation. An arrangement that is subject to Section 409A but that is not memorialized in writing will automatically violate Section 409A.

(c) Tax Reporting Requirements. Amounts deferred under a plan covered by Section 409A must be reported on Form 1099-MISC or Form W-2 for the year of deferral.¹³ Unlike the excise tax associated with Section 280G (relating to "golden parachute" payments) which, for employees, must be withheld by employers, the IRS has

¹³ IRS Notice 2005-94 indicates that no reporting will be required for amounts deferred in 2005. The IRS has indicated informally that it expects to issue further proposed regulations relating to the tax reporting and withholding requirements associated with Section 409A.

indicated that the additional taxes associated with Section 409A violations are not subject to mandatory employer withholding.¹⁴

5. Conclusion.

If you've made it this far, you have no doubt begun to sense the "through the looking-glass" nature of Section 409A and its regulations, particularly as they apply to employment agreements, bonus programs, severance plans, and the like. Complex and confusing though these new requirements may be, they do seem to be here to stay, and because of the serious consequences of violations to employees and contractors, employers can ignore these requirements only at their peril. Fortunately, the proposed regulations do offer a number of workable exceptions for common compensation and employment practices, thus sparing many employers, employees, and contractors from unnecessary entanglement with Section 409A. Some of the consequences of Section 409A may have been unintended, but at least the IRS has given us a way to manage them.

Timothy G. Verrall is an associate in the Orange County Office. He can be reached by telephone at (949) 251-7192 or by email at tverrall@mofo.com. Other members of Morrison & Foerster LLP familiar with Section 409A and its application in the employment context are Paul Borden and Patrick McCabe, both of whom are partners in the San Francisco Office. Mr. Borden can be reached at by telephone at (415) 268-6747 or by email at pborden@mofo.com. Mr. McCabe can be reached at by telephone at (415) 268-6926 or by email at pmccabe@mofo.com.

¹⁴ See Part 5 of IRS Publication 15-A "Employer's Supplemental Tax Guide" ([link](#)).