AMERICAN LAW INSTITUTE-AMERICAN BAR ASSOCIATION
LIMITED LIABILITY ENTITIES

Presentation on:
March 16, 2006

NON-QUALIFIED DEFERRED COMPENSATION
SECTION 409A AND PARTNERSHIPS

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1. Introduction.

New Section 409A enacted as part of the American Jobs Creation Act of 2004 has turned on its ear the taxation of non-qualified deferred compensation arrangements. A non-qualified deferred compensation arrangement exists when compensation is earned in a year prior to payment for the underlying services.[1] "Qualified" arrangements such as 401(k) plans are excluded from the application of Section 409A. At this point (February 12, 2006) two major pieces of guidance have been issued by the government: IRS Notice 2005-1 (January 10, 2005); and Proposed Regulations under Section 409A (October 4, 2005).

2. Selected Brief Overview of Section 409A.

Principal changes made by Section 409A:

a. The general rule is that income from deferred compensation arrangements may no longer be deferred past the year in which such compensation is earned, subject to certain exceptions and special rules.

b. On top of the current inclusion of income pursuant to deferred compensation arrangements (that fail to satisfy an exception or certain stringent criteria for deferral), an additional 20% tax on the amount of deferred compensation is also imposed on the service performer. Strangely, this may even be the case if: (i) the service recipient and service performer agree that the service performer will currently include compensation in the year in which it is earned, even though payment is deferred to a later year; and (ii) the service performer has a right to demand the payment early for reasons that do not constitute constructive receipt but yet do not satisfy the strict early payment requirements of Section 409A.

c. Employers may no longer use trusts to hold a participant's deferred compensation if the trust assets become protected from general claims of creditors upon a change in the employer's financial condition.

d. The benefits of using off-shore trusts for deferred compensation are substantially diminished.

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[1] Section 409A does not alter or effect the application of any other provision of the Code or common law tax doctrine which may separately require current inclusion of income. Accordingly, deferred compensation not required to be included in income under Section 409A may nevertheless be required to be included in income under Section 451, the constructive receipt doctrine, the cash equivalency doctrine, Section 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine. *See*, IRS Notice 2005-1, 2005-2 I.R.B. 274.

e. The scope of non-qualified deferred compensation arrangements is expanded to cover such things as severance pay arrangements, so-called "Section 457(f) plans" and certain equity-based compensation arrangements.

3. Exceptions to Current Inclusion.

a. An exception from current inclusion exists if the deferred compensation is subject to a substantial risk of forfeiture. A substantial risk of forfeiture exists for this purpose if the service performer's entitlement to such compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to the a purpose of the compensation, and the risk of forfeiture is substantial (*e.g.*, service performed if her employment is terminated before a future specified date).

b. The proposed regulations provide that short-term deferrals are not subject to Section 409A. A short-term deferral exists where amounts are received by the service performer by the later of (x) the 15th day of the third month after the end of the service performer's taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or (y) the 15th day of the third month after the end of the service recipient's taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

c. Section 409A does not require current inclusion of deferred compensation if the service performer uses the accrual method of accounting.

d. Section 409A does not require current inclusion if the service performer is an independent contractor who performs "significant" services for two or more unrelated entities, and the service performer is not related to the service recipient.

4. Application of Section 409 to Deferred Compensation Arrangements.

a. Except for "performance-based compensation" (discussed below), vested deferred compensation must be included in income in the year in which it is earned, unless certain qualifying deferral elections are made. In general, elections to defer compensation must be made prior to the first day of the calendar year in which the compensation is earned (*i.e.*, no later than December 31 of the preceding year for calendar year service providers). For new arrangements or for participants first becoming eligible in existing arrangements, the deferral elections may be made within thirty days after the participant becomes eligible for the deferred compensation (in which case the election pertains to compensation earned after the date of the election for the remainder of that year).

b. In the case of deferred compensation which is subject to a substantial risk of forfeiture requiring continued services for a period of at least 12 months, the initial deferral election may be made no later than 30 days after the date the individual receives the legally-binding right to the compensation, as long as the election is made at least 12 months prior to the date that the forfeiture condition could lapse.

c. Once made, Section 409A restricts a service performer's ability to change the election. In general, a change in the election must delay the participant's receipt of the payment for at least five years.

d. As a general rule, payments may not be accelerated.

5. Performance-based Compensation.

a. An exception to the general rules that service providers must make deferral elections prior to the start of the calendar year for which services for such compensation will be rendered, exists for performance-based compensation. Elections to defer performance-based compensation must be made no later than six months prior to the end of the performance period to which such compensation relates. Performance compensation is defined in the proposed regulations as compensation to which the payment or amount is contingent on the satisfaction of pre-established organizational or individual performance criteria over a performance period of at least 12 consecutive months.

b. The performance criteria must be in writing within 90 days after the performance period begins. The performance criteria must not be substantially certain to be satisfied at the time they are established. Subjective performance criteria are permissible so long as neither the service performer nor related party has any role in the subjective determination of whether the criteria had been satisfied.

6. Timing of Distribution.

a. If a deferral election has been made then distributions can be made only upon the occurrence of one of the following events:

(i) "Separation from service"

(ii) "Disability"

(iii) Death

(iv) "Change in control of the company"

(v) "Unforeseeable emergencies"

(vi) At the time or times specified in the arrangement at the date of deferral of such compensation

b. The above terms with quotation marks around them are very specifically defined under Section 409A. Therefore, the underlying documents need to conform to these definitions. Employers and service performers will not be permitted to deviate from these rigid definitions.

c. Arrangements may contain multiple permissible payments. By way of example, a deferred compensation arrangement may provide that payment will occur on the earlier of a specified time, disability or death. Exceptions exist for domestic relations orders, amounts needed to pay the income recognized pursuant to a violation of Section 409A or to pay employment taxes.

d. Similarly, service recipients generally may not unilaterally terminate a non-qualified deferred compensation arrangement and thereby accelerate payments, except in limited circumstances.

7. Section 409A and Equity-Based Compensation.

a. Section 409A is applicable to equity-based compensation arrangements in both partnerships (including LLCs) and corporations. Some of these equity-based compensation arrangements will be exempted from many of the requirements of Section 409A as long as the arrangement is not in-the-money at the date of grant.

b. Specifically, in this regard, non-qualified stock options with respect to certain common stock will not be subject to Section 409A if each of the following three conditions are satisfied:

(i) The exercise price is not less than the fair market value of the underlying stock on the grant date and the number of shares subject to the option as fixed at such grant date;

(ii) The transfer or exercise of the stock which is subject to the option, the subject of taxation under Section 83;

(iii) The option does not contain other deferred compensation arrangements.

c. Similarly, stock appreciation rights or ("SARs") with respect to certain common stock related to the service recipient's stock will not be subject to Section 409A if each of the following three conditions are satisfied:

(i) The SAR is not in-the-money on the grant date;

(ii) The SAR exercise price is never less than the fair market value of the stock on the grant date;

(iii) The SAR does not contain any other deferred compensation arrangement.

d. Importantly, the Proposed Regulations clarify that the above-described exceptions for non-qualified stock options and SARs apply only with respect to common stock, and only the class of common stock that as of the date of grant has the highest aggregate value of any class of common stock of the corporation outstanding, or a class of common stock substantially similar to such class of stock (ignoring differences in voting rights). The Proposed Regulations also clarify that the service recipients stock must not include any stock that provides a preference as to dividends or liquidation rights.

e. Modification of SARs or non-qualified stock options generally will trigger a re-testing of such stock right under Section 409A. There are a number of exceptions set forth in IRS Notice 2005-1 and the proposed regulations (including an exception relating to substitutions and assumptions and statutory options in connection with certain corporation transactions); however, extreme care must be taken with respect to any such modifications if a re-testing of the particular stock right would cause the arrangement to flunk Section 409A (*e.g.*, if the stock right is in-the-money at the re-testing date).

8. Application of Section 409A to Partnerships and LLCs.

a. Guidance on the application of Section 409A to partnerships is scarce. The preamble to the proposed regulations provides as follows:

> Arrangements between Partnerships and Partners. The statute and legislative history to Section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership, and do not explicitly exclude such arrangements from the application of Section 409A. The application of Section 409A to such arrangements raises a number of issues, relating both to the scope of the arrangements subject to Section 409A, and the coordination of the provisions of Subchapter K and Section 409A with respect to those arrangements that are subject to Section 409A. The Treasury Department and the IRS continue to analyze the issues raised in this area, and accordingly these regulations do not address arrangements between partnerships and partners. Notice 2005-1, Q&A-7 provides interim guidance regarding the application of Section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7.
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> Commentators have asked whether Section 409A applies to guaranteed payments for services described in Section 707(c). Until further guidance is issued, Section 409A will apply to guaranteed payments described in Section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right

to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

The Treasury Department and the IRS continue to request comments with respect to the application of Section 409A to arrangements between partnerships and partners.

b. IRS Notice 2005-1 Q&A-7 provides as follows:

The application of Section 409A is not limited to arrangements between an employer and employee. Accordingly, Section 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a non-qualified deferred compensation plan. However, until additional guidance is issued, for purposes of Section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest granted in connection with the performance of services under the same principles that govern the issuance of stock (*See*, Q&A-4). Specifically, until additional guidance is issued, for purposes of Section 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation.

Similarly, until additional guidance is issued, for purposes of Section 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock. The Section 409A rules governing other stock-based compensation may be applied by analogy to grants of equity-based compensation where the compensation is determined by reference to partnership equity. In addition, until further guidance is issued, taxpayers may treat arrangements providing for payments subject to Section 736 as not being subject to Section 409A, except that an arrangement providing for payments which qualify as payments to a partner under Section 1402(a)(10) are subject to Section 409A.

Finally, Section 409A may apply to payments covered by Section 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a non-qualified deferred compensation plan.

c. The foregoing guidance, although helpful, leaves a number of unanswered questions, particularly when payments to retired partners constitute payments to retired partners pursuant to Section 736 and guaranteed payments for services pursuant to Section 707(c). Further, the apparent application (subject to further guidance) of 409A to certain arrangements designed to provide retirement payments to retired partners for life (so as to qualify for the exemption from self-employment taxes provided under Section 1402(a)(10)) has also caused significant concern, primarily from many professional partnerships that currently have these arrangements in place.

d. The Taxation Section of the American Bar Association has submitted extensive comments on the application of IRC § 409A to partnerships.[2] Among the recommendations made by the ABA Tax Section are:

> (i) We recommend that Section 409A not apply to transactions between a partnership and a partner acting in his or her capacity as a partner that are treated as allocations of income under Sections 702 and 704 or distributions under Section 731.
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> (ii) We recommend that transactions that are treated under Section 707(a) as transactions between partnerships and partners not acting in their capacity as partners be subject to Section 409A in the same way and under the same circumstances as such transactions would be if they did not involve partners. Under this recommendation whether a transaction is treated as one between a partnership and a partner not acting in his or her capacity as a partner is to be determined under the principles of existing law, not principles developed solely for purposes of applying Section 409A. Further, we recommend that if a transaction is recharacterized under Section 707(a)(2)(A) as one between a partnership and a partner not acting in his or her capacity as a partner, the recharacterization not be given retroactive effect under Section 409A if the parties had a reasonable basis for believing that Section 707(a) did not apply.
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> (iii) We recommend that Section 409A not apply to guaranteed payments for services that are treated as transactions between a partnership and a non-partner solely for purposes of Section 61(a) and, subject to Section 263, Section 162(a).
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> (iv) We recommend that Section 409A not apply to payments made in liquidation of the interest of a retiring or deceased partner, regardless of whether they are Section 736(b) payments or

[2] The comments are available at http://www.abanet.org/tax/pubpolicy/2005/050520eb3.pdf.

Section 736(a) payments, and regardless of whether the Section 736(a) payments are guaranteed payments. We recommend that the same treatment apply to payments to terminated partners that are excluded from self-employment tax under Section 1402(a)(10).

(v) We recommend that options to purchase partnership interests be treated the same as nonqualified stock options under Section 409A.

(vi) We recommend that appreciation rights with respect to partnership interests be treated the same as stock appreciation rights ("SARs") under Section 409A. We agree with other commentators who recommend that the exemption for SARs from the definition of deferred compensation in Notice 2005-1 not require that stock subject to the SAR be publicly traded, and recommend that the same approach be taken for UARs.

(vii) We recommend that transfers of partnership interests be treated the same as transfers of corporate stock under Section 409A, i.e., as not involving a deferral of compensation for purposes of that section. In the case of transfers of profits interests, we believe there is no need to limit this exception to transfers that are treated under applicable guidance as not resulting in inclusion of income by the service-provider. We further recommend that regulations or a notice ("Regulations") make clear that changes in a partner's share of partnership income, unrealized appreciation, and capital from year to year, to the extent they might otherwise be viewed as new transfers of partnership interests, are likewise exempt.

(viii) We recommend that the substitution, assumption or modification of a partnership option or other equity award pursuant to a merger, acquisition, reorganization or similar transaction not be treated as the grant of a new option or other equity award or a change in the form of payment for purposes of Section 409A if (i) such substitution, assumption or modification is not subject to the discretion of the award recipients, (ii) the terms of the substitution, assumption or modification are determined solely by the partnership or jointly by the partnership and other parties to the transaction or by operation of law and (iii) similar terms apply to all award recipients.

(ix) We recommend that Section 409A(a)(2)(A)(v) be interpreted to allow distributions upon a change in ownership or effective control of a partnership.

(x) We recommend that Regulations clarify that "the person for whom the services are performed" includes not only an individual's common law employer (in the case of an employee) or the

> partnership of which the individual is a member (in the case of a partner) but also any company for whom the employee or partner performs services on any extended basis. We also recommend that the ownership level required for companies to be part of the same “service recipient” be reduced from 80% to a lesser but not trivial percentage, and other changes be made to the definition of “service recipient” to recognize the variety of other links that motivate companies to grant equity interests to individuals who are not their partners or employees. Finally, we recommend that Section 414(m) principles, and not merely Section 414(b) and (c) principles, be used to determine when companies are part of the same “service recipient”.

e. Pursuant to the Proposed Regulations and Announcement 2005-1, partnerships may use the rules governing stock-based compensation (*e.g.* SARs and options to acquire partnership interest) by analogy to the rules that apply to grants of equity-based compensation where the compensation is determined by reference to partnership equity. The Proposed Regulations also clarify that the relatively favorable application of Section 409A to SARs and non-qualified stock options applies only with respect to certain common stock, and narrowly defines “common stock” for this purpose to include only,

> “(i) the class of common stock that has as of the date of grant the highest aggregate value of class of common stock of the corporation (ignoring voting rights differences), and (ii) stock that does not provide a preference as to dividends or liquidation rights.”

The application of this test in the context of partnerships/LLCs may be more difficult and uncertain than in the corporate world. Pending the issuance of further guidance, practitioners should tread very carefully when using compensation tools analogous to SARs and stock options in the partnership/LLC world.

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