or contributed to, their individual accounts on the applicability date.

The final regulation also provides relief from the disclosure requirements for returns over a 5- and 10- year period for certain designated investment alternatives. For plan years beginning before October 1, 2021, if a plan administrator reasonably and in good faith determines it does not have information on expenses attributable to the plan that is necessary to calculate the 5-year and 10-year average annual total returns for a designated investment alternative not registered under the Investment Company Act of 1940, the plan administrator may use a reasonable estimate of such expenses or it may use the most recently reported total annual operating expenses of the investment alternative as a substitute for such expenses. If the plan administrator does so, it must inform the participants and beneficiaries of the basis on which the returns were determined.

Final Amendment to the Regulation under ERISA Section 404(c)

The final regulation also amends the rules applicable to ERISA § 404(c) plans, compliance with which will exempt the plan's fiduciaries from liability for investment decisions made by participants and beneficiaries. This amendment integrates the new disclosure requirements of the final regulation for section 404(a) into the existing section 404(c) regulation to avoid having different disclosure requirements for plans intending to comply with the ERISA § 404(c) requirements. Accordingly, all self-directed individual account plans must comply with the new disclosure regulations. The DOL also reiterated its view that the disclosure requirements embodied in the final regulation do not relieve a fiduciary from its duty to prudently select and monitor service providers or designated investment alternatives offered under the plan.

Mr. Bogner and Mr. Weinstein are partners in Proskauer's Employee Benefits, Executive Compensation & ERISA Litigation Practice Center, resident in Proskauer's New York Office. Mr. Hirschhorn is a senior associate in Proskauer's Employee Benefits, Executive Compensation & ERISA Litigation Practice Center, resident in Proskauer's New York Office. Mr. Spencer is an associate in Proskauer's Employee Benefits, Executive Compensation & ERISA Litigation Practice Center, resident in Proskauer's New Orleans Office. Proskauer's ERISA Litigation Newsletter is a monthly publication that provides an analysis of ERISA cases and developments that may be of interest, or that may reflect emerging trends, including how they can impact employers, plan fiduciaries, plan administrators, trustees or plan service providers.

[1] Such general plan administrative expenses may include legal, accounting and recordkeeping fees, that may be charged against, or affect the balance of, individual accounts.

[2] Such individual expenses may include fees attendant to processing plan loans or qualified domestic relations orders, fees for investment advice, fees for brokerage windows, commissions, front or back-end loads or sales charges, redemption fees and similar expenses, and optional rider charges in annuity contracts.

[3] Such shareholder type fees may include commissions, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, and purchase fees.

[4] FAB 2006-03 provides: "To help achieve long-term retirement security, you should give careful consideration to the benefits of a well-balanced and diversified investment portfolio. Spreading your assets among different types of investments can help you achieve a favorable rate of return, while minimizing your overall risk of losing money. This is because market or other economic conditions that cause one category of assets, or one particular security, to perform very well often cause another asset category, or another particular security to perform poorly. If you invest more than 20% of your retirement savings in any one company or industry, your savings may not be properly diversified. Although diversification is not a guarantee against loss, it is an effective strategy to help you manage investment risk."

Executive Compensation Plans [Deferred Compensation]

Section 409A

Six Years of 409A

Contributed by Richard W. Skillman, Caplin & Drysdale, Chartered

Introduction

Six years after its enactment in 2004, section 409A of the Internal Revenue Code, 26 U.S.C. § 409A, has developed to be almost everything a tax statute should not be. It imposes extraordinary tax penalties on employees and other service providers who participate in nonqualified deferred compensation plans that do not comply (either in form or operation) with its rigid requirements, without regard to whether such taxpayers bear any responsibility for the noncompliance. Because the regulations governing the scope and requirements of section 409A are a technical thicket of tightly drawn rules, formalistic and benign compliance errors by employers are likely to be commonplace. In most instances, those errors will have conferred no financial or tax benefit on employees or resulted in any loss of tax revenues. However, in the eyes of section 409A, concepts such as "no harm no foul," substantial compliance, and blamelessness of the taxpayer make no difference. Thus, if section 409A is rigorously enforced by the IRS, it will largely function as a high-stakes "gotcha" statute, though the vast majority of compliance errors will likely go undetected by anyone, without harm to the tax system or benefit to taxpayers.

In contrast with other tax penalties that Congress has created or increased in recent years, section 409A was not enacted to deter or punish tax avoidance or aggressive tax reporting. Nor was section 409A enacted to limit revenue losses from the use of nonqualified deferred compensation plans; section 409A imposes no limit on the amount of compensation that may be deferred, and tax deferral at the employee level is matched by deferred deductions at the employer level under the vast majority of deferred compensation arrangements to which section 409A applies.[1] Rather, section 409A reflects the congressional judgment that the longstanding tax principles that had governed the federal income tax treatment of nonqualified deferred compensation plans — in particular, the loosely defined constructive receipt doctrine — effectively allowed executives and other employees to exert inappropriate control over the time when deferred compensation was paid. This policy judgment was ignited by the much-publicized payment of deferred compensation balances to certain Enron executives as their sinking ship left rank-and-file employees with qualified plan accounts funded with worthless Enron stock. The fact that the Enron plans did not run afoul of prevailing constructive receipt interpretations led to the conclusion that more clear-cut and restrictive tax rules were needed for nonqualified deferred compensation plans.

However, Congress has enacted thousands of restrictive tax rules, and, except as a backlash to Enron, there is no explanation for why it chose to impose such punitive sanctions for failure to satisfy the requirements of section 409A. As a consequence of those sanctions, section 409A has been magnified far beyond its relative importance to the tax system. The Treasury and IRS have produced voluminous regulations and related guidance under section 409A, and corporate employers have spent enormous amounts in their efforts to avert noncompliance. Nonetheless, the risk of unintentional noncompliance remains high, and that will pose compliance dilemmas that taxpayers and the IRS should not have been required to face.

Overview of Section 409A

In a few respects, the requirements of section 409A are straightforward and consistent with prior interpretations of the constructive receipt doctrine, including the requirement that employees who voluntarily elect to defer future compensation under a nonqualified deferred compensation plan irrevocably elect to do so before the beginning of the year in which the compensation is earned, with an exception for newly hired and newly eligible employees. In other respects, however, section 409A goes far beyond a tightening of the constructive receipt doctrine and the prevention of accelerated payments to executives of failing companies.

First, section 409A imposes rigid rules on when deferred compensation may be paid, limiting payment to six permissible payment events.[2] Second, it requires the time and form of future deferred compensation payments (*e.g.,* a lump sum or periodic installments) to be fixed before compensation is initially deferred, subject to a limited right to re-defer payments for a minimum period of five years. Third, to preclude Enron-type bail-out payments, section 409A broadly prohibits accelerated payments of nonqualified deferred compensation, even if made by a financially healthy company, and further requires that payments to key executives of public companies be delayed for six months after their termination of employment. Lastly, section 409A contains restrictions on the use of "rabbi" trusts (*i.e.,* trusts the assets of which are reachable by the employer's general creditors in the event of insolvency) as funding vehicles for nonqualified deferred compensation plans, including offshore rabbi trusts and those funded upon a downturn in the employer's financial health.

The Penalty for Noncompliance

Noncompliance with any of these requirements — including the maintenance of a written plan document that contains noncompliant provisions that may never have operational effect — triggers astonishingly punitive tax consequences. To illustrate, assume that a top executive of a public company is entitled to receive quarterly payments of $50,000 for life under a supplemental executive retirement plan ("SERP") that have a present value of $3 million on the date of the executive's retirement. Further assume that the first of these $50,000 payments is made three months after the executive's retirement in violation of the six-month delayed payment requirement of section 409A. In that case, section 409A would subject the executive to immediate income tax at regular rates on the entire $3 million value of the SERP benefit, plus an additional 20% tax and a premium interest tax. Further, the employer would be obligated to report the $3 million amount on the employee's Form W-2 under a coding to show that such amount is subject to the section 409A tax.[3] In this example, the combined section 409A tax in the year of the $50,000 early payment could exceed $2 million.

The same measure of tax can be imposed for a wide range of benign compliance errors, including an improper definition of termination of employment in a plan document or an improper definition of "change in control," even if there is little likelihood that such definitional defects will actually affect the operation of the plan or a particular employee. Thus, it is not sufficient that a deferred compensation plan is operated in accordance with the requirements of section 409A. The plan document must also be error-free. If a provision of the written plan document fails to comply with the requirements of section 409A, the value of the vested deferred compensation rights of all participants in the plan is subject to immediate section 409A tax.

Though none of the components of the section 409A tax is technically classified as a tax penalty, the purpose and effect is the same. By contrast, the civil tax penalties for substantial understatements of reported income, negligent disregard of rules or regulations, and even for fraudulent underpayment of tax are generally much lower[4] and also subject to abatement upon a showing of reasonable cause and good faith. No such abatement of the section 409A tax is available to employees, who typically bear no responsibility for section 409A compliance errors or even have reason to know that compliance errors have occurred. [5] As further discussed below, the IRS has prescribed correction procedures to mitigate (and in some cases eliminate) these punitive tax consequences where the compliance errors are inadvertent and timely corrected and disclosed to the IRS. However, responsibility for such corrections falls on the employer, and if the employer fails to timely discover and correct a compliance error in accordance with the IRS procedures, no other relief is available to the employee.

This penalty regime would be excessive and mis-directed even if section 409A imposed simple bright-line rules, but that is far from the case. The IRS has already issued hundreds of pages of regulations and explanatory guidance under section 409A, including lengthy final regulations covering the general requirements of section 409A, proposed regulations relating to the valuation of unpaid deferred compensation that becomes taxable under section 409A, eleven notices relating to transitional issues, three notices governing correction of compliance errors, and four other notices relating to such diverse subjects as the application of section 409A to public school teachers who are paid over 12 months for services performed during a 10-month school year, employees of TARP recipients, and employees insured under split-dollar life insurance arrangements. The IRS has yet to propose regulations addressing the section 409A restrictions on funding arrangements, which are likely to add another layer of complexity and uncertainty.

The Section 409A Regulations

The centerpiece of the existing regulatory regime is an intricate set of final regulations that give exacting meaning to the core requirements of section 409A. These regulations are cast in the form of detailed rules with exceptions (and in some cases exceptions to those exceptions) that leave little room for applying general principles in situations not specifically addressed in the regulations. The specificity and rigidity of the regulations reflect the concerns of the IRS and Treasury (as repeatedly expressed in the preambles to the proposed and final regulations) that more generalized and flexible rules would be manipulated by executives to circumvent the requirements of section 409A. The result is a technical minefield for those who are not vigilant to the fine details as well as interstitial ambiguities for those who are. The following is a tree-top view of those regulations.

For starters, the regulatory definition of a "nonqualified deferred compensation plan" covered by section 409A is far more encompassing than the common understanding of that term as well as its meaning under other provisions of the Internal Revenue Code.[6] Subject to exceptions, section 409A has been made applicable to employment agreements that include severance provisions, bonuses that are paid more than 2½ months after the year in which they are awarded, and fringe benefits that extend beyond termination of employment. Thus, a single provision in an agreement with a single employee may constitute a "plan" subject to section 409A. Stock options and stock appreciation rights are exempt from section 409A, but only if issued on a nondiscounted basis (for this purpose, the regulations contain detailed rules for valuing stock that is not publicly traded), and that exemption may be lost if the options are modified or extended. Section 409A may also apply to foreign arrangements that cover U.S. citizens and residents; in this respect, the regulations seem to assume that foreign employers whose plans do not fall within the narrowly drawn exceptions that the regulations provide for foreign plans should be cognizant of the section 409A implications for their U.S. employees.

Lastly, this segment of the section 409A regulations includes aggregation rules that treat multiple plans within nine enumerated categories as a single plan. Thus, if there is an event of noncompliance for one of the plans within a category, the punitive section 409A tax is imposed on the value of the employee's vested deferred compensation rights under any other plan in the same category.

The regulatory definitions of the permissible payment events and permissible times and forms of payment upon the occurrence of such events are equally formidable. The definition of termination of employment contains quantitative presumptions (based on a three-year look back period) for when a reduction in the level of an employee's services may or may not be treated as a termination of employment, as well as rules governing when leaves of absence are respected as such and when asset acquisitions and other corporate transactions give rise to a termination of employment. There are detailed rules governing how and when the key employees of public companies must be identified for purposes of implementing the six-month delayed payment requirement for such employees following termination of employment. A plan may provide for payment upon a change in the ownership or control of a corporation or a change in the ownership of a substantial portion of the corporation's assets, but only if the plan document defines that payment event based on the minimum change thresholds set forth in the regulations.[7]

Not only must the time and form of payment be established before compensation is initially deferred,[8] but all payments must actually be made in accordance with the pre-established payment schedule (within prescribed tolerances) in order to avoid a violation of section 409A. A plan may not allow payments to be delayed for normal business reasons, such as a requirement that a terminating employee execute a release of claims before receiving payment. In limited circumstances, the regulations permit alternative times and forms of payment depending on when payment events occur. For example, a plan may have different times and forms of payment for termination of employment before or after a specified age, or may provide for payment upon the earlier or later of termination of employment or attainment of a specified age. On the other hand, a plan generally may not allow for different times and forms of payment depending on the circumstances under which a termination of employment occurs; thus, a plan may not allow one form of payment for voluntary termination of employment and a different form of payment for involuntary termination of employment. An employer, for its own reasons, may wish to cut its ties with a discharged executive by renegotiating and cashing out the executive's deferred compensation at that time, but that would nonetheless violate section 409A if it altered the previously established payment schedule. An under-advised executive could bear a very high tax cost for agreeing to such terms.

IRS Prescribed Correction Procedures

Implicitly recognizing the potential inequity of this regime as well as the high likelihood of unintentional compliance errors, the IRS has published elaborate correction procedures covering both operational and documentary errors under section 409A. The correction procedures are confined to inadvertent errors and may not be utilized if the taxpayer is under examination by the IRS; moreover, correction of documentary errors is unavailable if the employer's deferred compensation plan is under examination. These correction procedures impose varying conditions and levels of penalties on different categories of compliance errors, reflecting the unstated judgment that some inadvertent mistakes are less forgivable than others. Most operational errors that are detected within the same or the following year can be corrected with no penalty or a substantially reduced penalty. The conditions for correction of noncompliant plan documents are more problematic. After 2010 (when most document defects may be corrected without penalty), document correction may result in the imposition of significant penalties on employees who happen to experience a change of job status within one year after the document correction.

In addition, the IRS correction procedures for both operational and documentary errors require statements to be attached to the tax returns of employers and affected employees (including potentially affected employees in the case of document corrections) and, to the extent required under the applicable provision of the correction procedure, amended tax returns must be filed and applicable section 409A taxes must be paid. Unless all of the timing, reporting, and other correction conditions are satisfied by the employer, the employee is theoretically subject to all of the tax sanctions that section 409A imposes.

The Section 409A Transition Period is Now Ending

The first six years of section 409A have primarily been a period of transition. Prior to 2009, when the final regulations became effective, compliance with section 409A was generally based on a "reasonable good faith" standard, and thus there was minimal risk that interpretive errors or operational foot-faults would give rise to the section 409A tax sanctions. Employers were also given until December 31, 2008 to conform their written plan documents to the requirements of the section 409A regulations. This was a major undertaking that caused large employers across the country to pay hundreds of millions of dollars of professional fees to minimize the risk of noncompliant plan documents, scarcely the most productive use of corporate resource. Employers have now been given a reprieve until the end of 2010 to make belated corrections to plan documents, provided they satisfy all of the procedural requirements for such corrections. Thus, the transition period is now coming to an end.

What Standard of Compliance will be Applied?

To date, the IRS has engaged in only limited examination activity under section 409A, and it remains to be seen how the IRS will enforce section 409A in the examination of tax returns for 2009 and later years to which the final regulations apply. For the examination of large employers, the IRS has begun using a standardized information request that requires the employer to provide detailed information concerning its nonqualified deferred compensation plans and the participants in such plans. However, it is not yet known how the IRS will process this information. Will Revenue Agents be trained and instructed to look only for clear-cut cases of noncompliance with section 409A? Will examinations be conducted in accordance with consistent norms across the country? Will Revenue Agents who examine small and medium-sized employers be instructed to look for section 409A violations at all?

When the IRS does conduct section 409A examinations for 2009 and later years, it will likely find numerous compliance errors of a technical nature, if it chooses to look for them. In the nearly two years that the final regulations have been in effect, our firm has been consulted on dozens of actual or arguable compliance errors that have arisen under the section 409A plans of a broad cross-section of employers. We have yet to see a single instance in which an affected employee had any responsibility for the error or derived any benefit from it, much less a case where there was any intent to violate or circumvent the requirements of section 409A. In most cases, an administrative oversight caused a late or early payment or an underpayment or overpayment, or the terms of an agreement with an individual employee did not include specific language needed to assure documentary compliance with section 409A.

Though practitioners feel ridiculous telling clients that foot-faults of this nature present tax compliance problems, we have nonetheless advised that the only way to assure that such errors will not give rise to severe adverse tax consequences is to follow all of the conditions of the applicable correction procedure. While the correction procedures are cumbersome, our clients have generally decided to follow them. However, for every section 409A compliance error that is detected and corrected under the IRS correction procedures, there will almost certainly be hundreds that are not. There are too many ways for technical compliance requirements to be misunderstood or overlooked, and for operational errors to arise, to expect otherwise. Even large compliance-oriented employers will not always be able to monitor everything their payroll departments and third-party payors have done to carry out the terms of their plans or even to identify all of their agreements with individual employees that constitute "plans" within the scope of section 409A. Smaller, less sophisticated employers may have little or no awareness of section 409A itself, much less of its scope or exacting compliance requirements.

Even assuming that the IRS follows a rule of reason in its examinations of nonqualified deferred compensation plans, that will only be a partial solution to the problems section 409A has created. If the IRS limits imposition of section 409A sanctions to clear cases of noncompliance by large employers, there will still be inequity at the employee level if employees are required to pay significant tax penalties for their employers' mistakes. While employers might agree to reimburse employees for the penalty taxes, the cost of doing so could become prohibitive if the reimbursements were taxable and employers needed to gross-up the reimbursements to make employees whole.[9]

For the much larger number of compliance errors that will never be examined by the IRS, employers will confront the question whether they too can follow a rule of reason and not feel constrained to incur the cost and paperwork burden of formally correcting every compliance error they happen to identify. However, if they do not, they will still have a legal obligation to report their own section 409A compliance errors on the W-2s of their employees, subjecting the employees to section 409A tax on amounts that may be many times greater than the amounts involved in the errors. It is never healthy for tax rules to be made so exacting that taxpayers are tempted to look the other way, but that will inevitably be the consequence of section 409A.

Richard Skillman is a member of Caplin & Drysdale, Chartered, in Washington, D.C. He advises and represents public companies and other taxpayers on a wide range of tax matters, including executive compensation. He formerly served as Deputy Chief Counsel and Acting Chief Counsel of the Internal Revenue Service.

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[1] Congress separately addressed the tax revenue implications of nonqualified deferred compensation arrangements maintained by tax-indifferent service recipients (such as the deferred fee arrangements between offshore hedge funds and their U.S. managers) through the enactment of section 457A (26 U.S.C. § 457A) in 2008. In contrast with section 409A, which imposes rigid structural requirements on nonqualified deferred compensation arrangements but does not limit tax deferral itself, section 457A imposes current tax on compensation deferred (beyond the following year) from tax-indifferent entities. Section 457A poses a whole separate set of problems (particularly in its potential application to U.S.-employees of multinationals) that are beyond the scope of this article.

[2] The only permissible payment events under section 409A are: (1) separation from service (*i.e.,* termination of employment in the case of an employee), (2) a specified time (such as an employee's attainment of a specified age), (3) death, (4) disability, (5) an unforeseeable emergency, or (6) a change in the ownership or control of an employer corporation (or in the ownership of a substantial portion of its assets).

[3] The employer would also be obligated to withhold the regular income tax on the value of unpaid deferred compensation that is taxable under section 409A and could be assessed for that withholding tax if it failed to do so. The regulations permit an accelerated payment of deferred compensation that becomes subject to section 409A tax, thereby enabling the employer to satisfy its withholding liability by reducing deferred compensation payments to the employee. The employer has no liability for the other elements of the section 409A tax, *i.e.,* the additional 20% additional tax and the premium interest tax. The premium interest tax is an augmented form of deficiency interest (determined at the interest rate on tax deficiencies plus 1 percent) measured from the year or years in which deferred compensation benefits become vested.

[4] By itself, the additional 20% tax imposed by section 409A (not counting the premium interest tax and the implicit penalty of accelerated regular tax on unpaid deferred compensation) substantially exceeds the normal 20% civil penalty for negligence and substantial understatement of income because it is imposed on the total amount of the deferred compensation and not on the underpayment of tax. All elements considered, the penalty components of the section 409A tax may exceed the 75% civil fraud penalty, which the IRS imposes only in very egregious circumstances.

[5] Nonetheless, the employee is theoretically obligated to self-assess the full section 409A tax on his or her own Form 1040, whether or not the employer has satisfied its obligation to identify the compliance error on the employee's Form W-2.

[6] Notably, section 3121(v)(2) of the Code, 26 U.S.C. § 3121(v)(2), provides special rules for the timing of FICA tax on employees' payment rights under "nonqualified deferred compensation plans." Like section 409A, section 3121(v)(2) provides no detailed statutory definition of that term, but the regulations under section 3121(v)(2) define a much narrower class of arrangements that are so classified.

[7] In general, such a change must be defined as at least a 50% change in stock ownership, an acquisition by a person or group of at least 30% of voting power, or a replacement of a majority of the board.

[8] The regulations permit different times and forms of payment to be elected or established for amounts deferred in successive years, but that is not an administrable option for most plans. In the case of a deferred benefit SERP or similar plan that does not periodically credit discrete amounts of deferred compensation to an employee's individual account, compensation is considered to be deferred in the year in which benefits are accrued for services rendered in that year.

[9] For example, assume an employer agreed to reimburse an employee for the penalty portion of the section 409A tax (*i.e.,* the portion in excess of the immediate tax at regular rates), and the penalty portion (the 20% additional tax plus the premium interest tax) equaled 25% of the value of the employee's deferred compensation. If that reimbursement was considered to be taxable compensation and the employee's combined federal and state marginal tax rate was 45%, a grossed-up reimbursement of the penalty tax would nearly double the cost of the penalty tax. It is debatable, however, whether reimbursement of the penalty portion of the section 409A tax would be properly treated as taxable compensation.

Benefit Claims

Beneficiary Designations

Southern District of Ohio Rules Plaintiff Was a Beneficiary Under Group Life Policy

Wray v. Fleck, No. C-1-08-852, 2010 BL 213548 (S.D. Ohio Sept. 14, 2010)

The U.S. District Court for the Southern District of Ohio granted a beneficiary's motion to reverse an administrative decision of an ERISA plan administrator, ruling that the beneficiary was not equitably estopped from seeking proceeds of a group life insurance policy, and that a signed beneficiary election form adequately evidenced the beneficiary's status under the policy.

The Group Life Insurance Policy

The Cooperative Group Benefits Plan Trust is an ERISA Plan and an insured under a group life policy issued by American United Life Insurance Co. (AUL). Southwest Landmark, Inc., James Fleck's employer, was an "Insured Unit" under the policy. *Wray* at 1. The policy allowed Fleck to name or change beneficiaries through a signed and dated request to AUL.

Fleck died on June 16, 2007. In June 2007, Employee Benefit Management Corporation (EBMC), a manager of self-funded benefit programs, wrote to Elfriede Wray, Fleck's girlfriend at his time of death, informing her that she was a beneficiary under the policy. EBMC thereafter wrote to AUL, advising that the necessary documentation to pay the total amount of $354,000 in benefits under the policy was enclosed, and requested that AUL distribute the benefits to the