

Navigating Deferred Compensation In A Post 409A/Enron Environment

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**Los Angeles Estate
Planning Council**



Today's Presenters



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- TO DO :
 - > FIRM IN PROGRESS
 - > FIRM PER. N.Y.
 - > AER. COST
 - > "TRUCK" RENTAL "TRUCK"
 - > INVOICE NUMBER ASSIGNMENT
 - > CALL JOHN
 - > GARY MANDER PER. COMMUNICATION
 - > TAX N.Y. FIRM
 - > B-DAY PRESENT. ADDRESS
 - > DROP BIRTH CERTIFICATE
 - > CELL PHONE. BATTERY
 - > BIRTHDAY MAP
 - > PROCEEDING RELEASE FRANKS < DANN TOWER >
 - > HUG & SOUTHWEST BOOKS
 - > SPRING GREENS FOR IGON GRAPHICS
 - > FILM
 - > TIME CARDS
 - > SCAMPS
 - > LANNY'S B-DAY FRAME
 - > NEW LICENSE RATES
 - > ICE FOOD FOR MAX & ROCKY
 - > CHANGE OIL & BRAKE FLUID
 - > POST OFFICE KEY FROM BETH

Importance of Section 409A

If a “nonqualified deferred compensation plan” fails to meet the requirements of Code Section 409A, the service provider (i.e. the person performing the services):

Is required to immediately include as ordinary income all amounts payable under the plan (discounted to present value) and under any plan that is required to be aggregated with the plan and...

... is required to pay a penalty tax equal to 20% of the value of the amounts payable under the plan.

If the service provider is subject to income taxes in the State of California, the California Franchise Tax Board (“FTB”) takes the position that an additional 20% penalty is payable to California.



Nonqualified Deferred Compensation



A nonqualified deferred compensation plan for purposes of Code Section 409A is defined as any plan or arrangement pursuant to which a service provider may receive compensation in a taxable year later than the year in which the service provider first has a legally binding right to the payment.



Exceptions to Code Section 409A

Short-Term Deferrals

A short-term deferral occurs where absent an election by the service provider to otherwise defer compensation, a payment is actually or constructively received by the service provider by the later of the 15th day of the 3rd month beginning after the end of the service provider's OR service recipient's taxable year in which a substantial risk lapses.

Where a payment is not subject to a substantial risk of forfeiture, the payment is deemed to no longer be subject to a substantial risk of forfeiture when the service provider first has a legal right to the payment.

The arrangement must not otherwise defer the payment to a later period



Substantial Risk of Forfeiture

Compensation is subject to a substantial risk of forfeiture if entitlement to the amount 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 the possibility of forfeiture is substantial.

A condition related to a purpose of the compensation must relate to the service provider's performance of services for the service recipient or the service recipient'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).

If a service provider's entitlement to the amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.

An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services.



Payment To Independent Contractors

Does not apply to payments made to independent contractors who meet certain safe harbor requirements

Understanding these rules depends upon interpreting what receipts are deemed to be received in a year

The safe harbor applies to an arrangement between an independent contractor and an unrelated service recipient if during the service provider's taxable year in which the service provider obtains a legally binding right to the deferred amount, the service provider is actively engaged in the trade or business of providing services (other than as an employee or as a director of a corporation) and provides significant services to two or more service recipients to which the service provider is not related and that are not related to one another and the revenues generated from the services provided to any service recipient or group of related service recipients during such taxable year do not exceed 70% of the total revenues generated by the service provider from the trade or business of providing such services.



Exceptions to Code Section 409A

Stock Options & Stock Appreciation Rights

**Stock Options
Not Subject To
Code 409A**

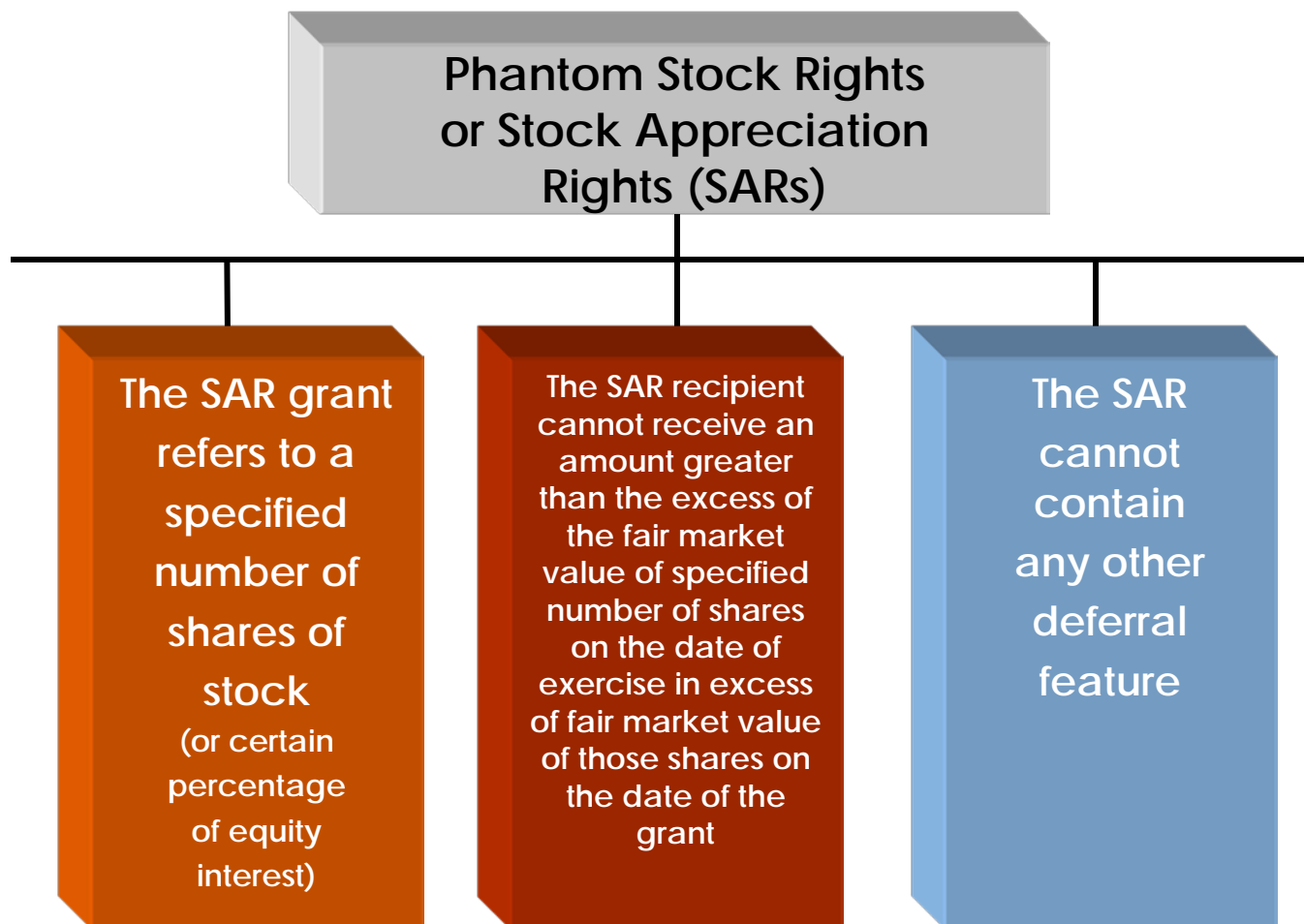
**Service Provider
Must Receive
Stock of Service
Recipient**

**Fair Market Value Of
Not Publicly Traded
Stock Must Be
Determined By A
Reasonable Application
Of Reasonable
Valuation Method**

**Discounted Stock
Options Will Violate
Code Section 409A
Unless They Meet
Short-Term
Deferral Rules**



Exceptions to Code Section 409A



Application of Code Section 409A

Requirements



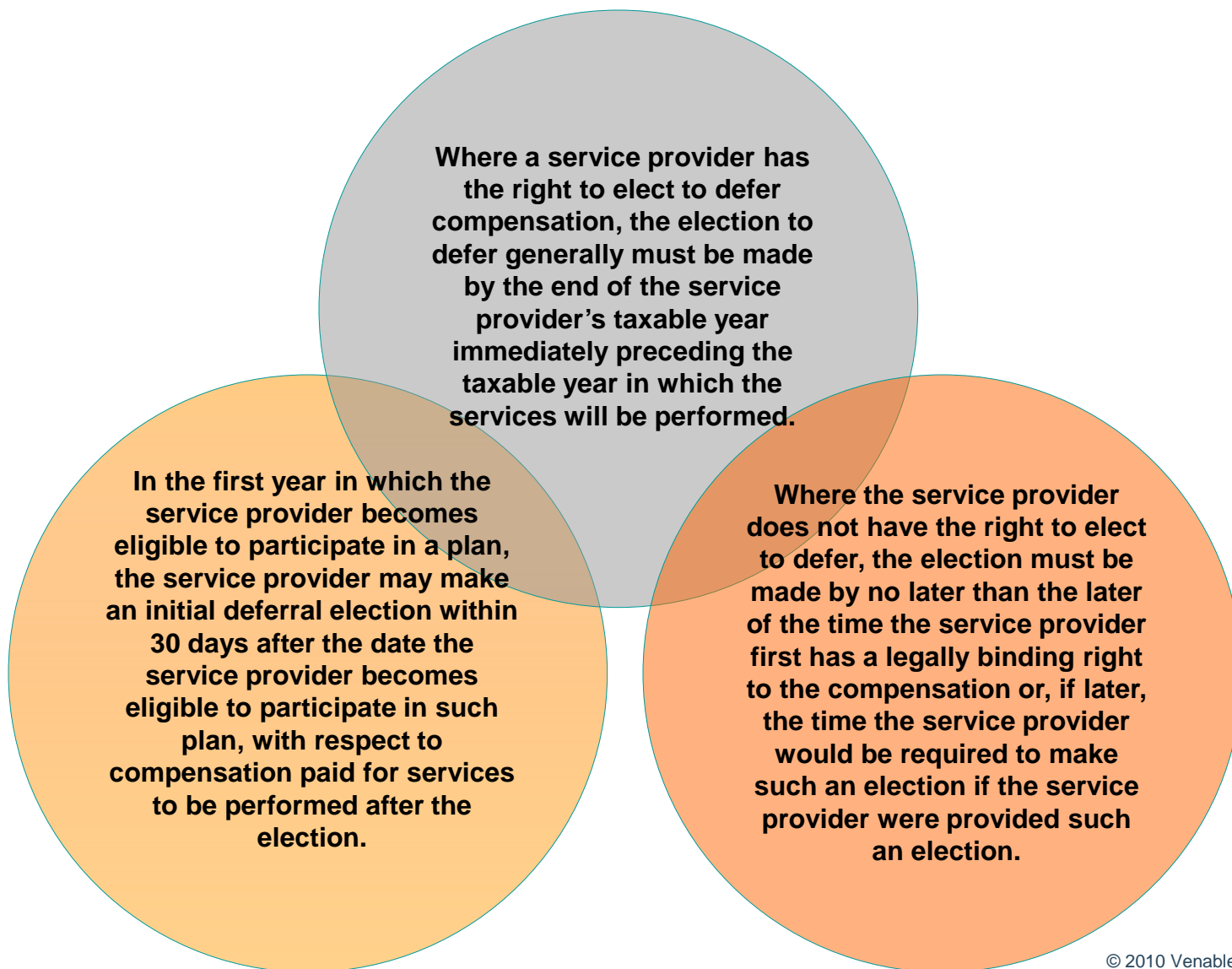
An election requirement

A time of payment requirement

Rules prohibiting acceleration of payment once an election has been made



Election Requirement



Subsequent Deferral Elections

Deferral Elections

Once the service recipient has made or been deemed to make an election, the service recipient cannot change the election to further defer the election unless the following requirements are met:

Requirement

The plan requires that such election may not take effect until at least 12 months after the date on which the subsequent deferral election is made;

Requirement

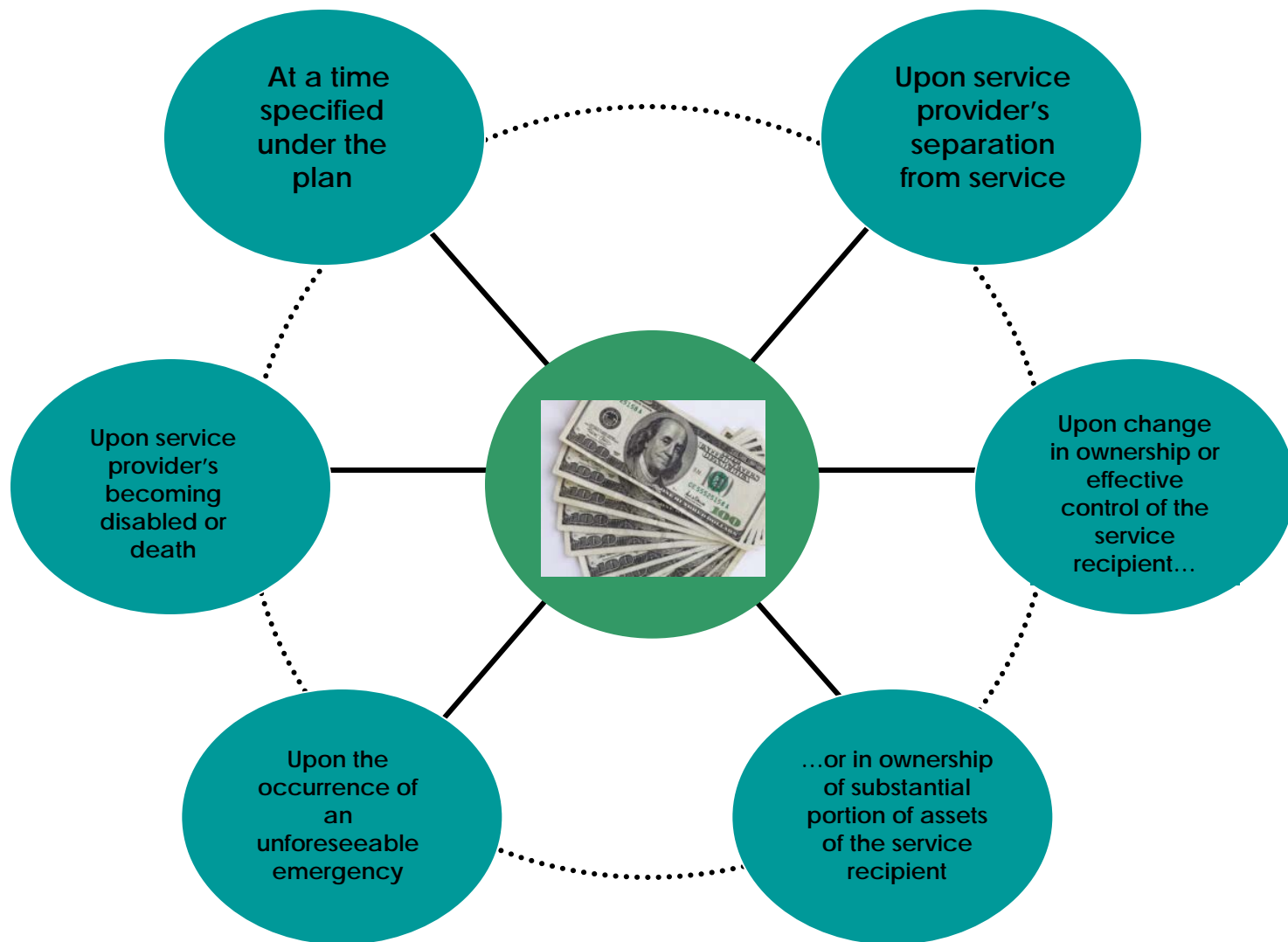
In the case of an election that is not related to a payment on account of disability, on account of death or on account of the occurrence of an unforeseeable emergency, the plan requires payment with respect to which such election is made must be deferred for a period of not less than 5 years from the date such payment would otherwise have been paid and...

Requirement

...the plan requires that any election related to a payment at a specified time or pursuant to a fixed schedule may not be made less than 12 months before the date the payment is scheduled to be paid.



Time & Form of Payment Requirements



Time or Fixed Schedule

This can be a fixed date such as September 11, 2011.

It can be any time that is objectively determinable and nondiscretionary at the time the event occurs.

For example, the release of a motion picture.

It can also be a designated taxable year of the service provider (i.e. the taxable year of the service provider occurring after the release of a motion picture) if the period of time does not span more than one taxable year or a period of no longer than 90 days even if the period straddles two taxable years, as long as the service provider cannot designate the taxable year in which the payment will be made.



Service Provider's Separation From Service

If the period of leaves exceeds six months and the individual's right to reemployment is not provided either by statute or by contract, the employment relationship is deemed to terminate on the first date immediately following such a six-month period.

An employee is considered to have separated from service with the service recipient if the employee dies, retires or otherwise has a termination of employment with the employer.

However, the employment relationship is treated as continuing intact while the individual is on military leave, sick leave or other bona fide leave of absence if the period of such leave does not exceed six months, or if longer, so long as the individual's right to reemployment with the service recipient is provided either by statute or by contract.

Under the regulations, whether a termination of employment has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20% of the average level of bona fide services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or the full period of services to the employer if the employee has been providing services to the employer less than 36 months).



Special Rule: Specified Employees



If a service provider is a specified employee as of the date of a separation from service, the rules permitting a payment upon a separation from service are satisfied only if payments may not be made before the date that is six months after the date of separation from service. Specified employee rules only apply to certain highly compensated employees of publicly held corporations.



Separation Pay Plans

Separation Pay Plans Meet The Following Requirements

1

The separation pay (other than reimbursements and certain other separation payments) may not exceed two times the lesser of:

- (a) the sum of the service provider's annualized compensation based upon the annual rate of pay for services provided to the service recipient for the taxable year of the service provider preceding the taxable year of the service provider in which the service provider has a separation from service with such service recipient (adjusted for any increase during that year that was expected to continue indefinitely if the service provider had not separated from service), or
- (b) the maximum amount that may be taken into account under a qualified plan pursuant to Code Section 401(a)(17) (\$245,000 for 2009) for the year in which the service provider has a separation from service; and

2

The separation pay must be paid no later than the end of the second taxable year following the taxable year in which the separation from service occurs.



The amount is payable to an employee only upon an involuntary separation from service or for “good reason” as defined in the Treasury Regulations.



Reimbursement Plans

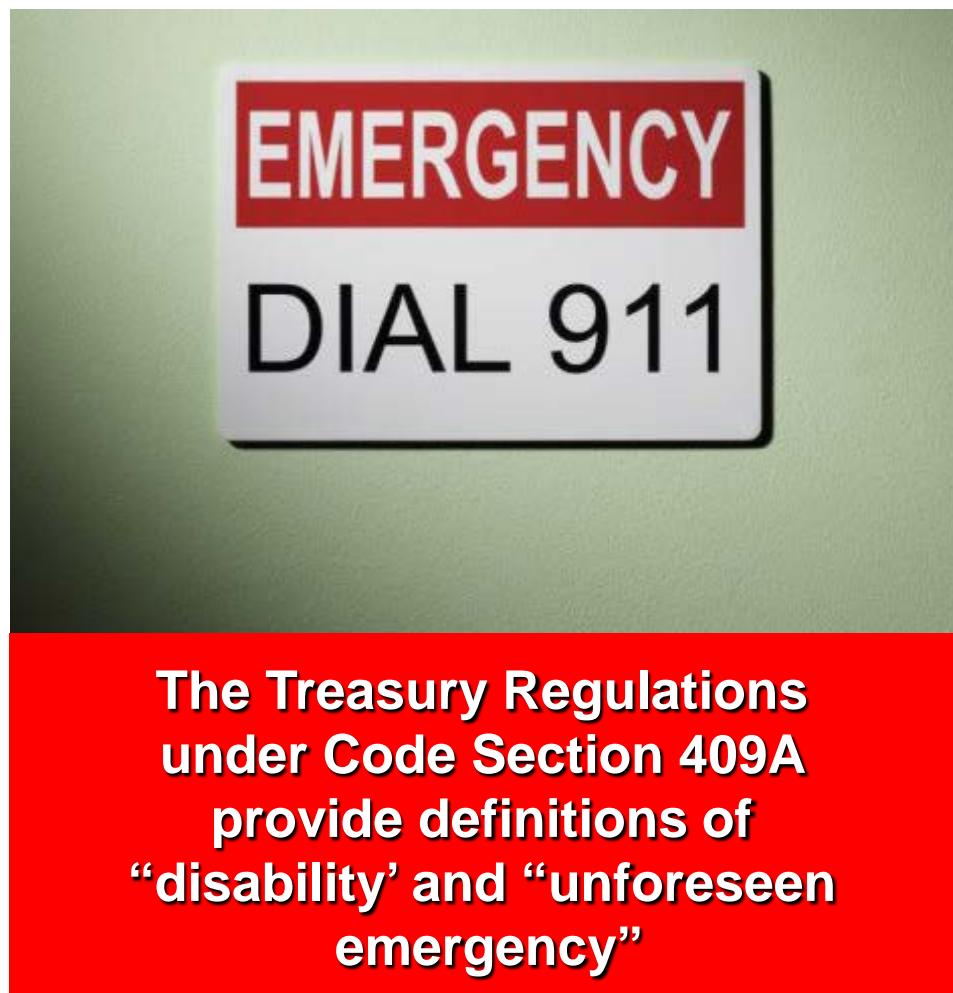
Certain reimbursement arrangements related to a termination of services are not covered by Code Section 409A, to the extent that the reimbursement arrangement covers only expenses incurred and reimbursed before the end of the second year following the year in which the termination occurs.

The types of reimbursement arrangements excluded include reimbursements that are otherwise excludible from gross income for expenses that the service provider can deduct under Code Section 162 or 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), outplacement expenses, moving expenses, medical expenses, as well as any other types of payments that do not exceed a certain aggregate amount during any given taxable year.

Reimbursement arrangements include the provision of in-kind benefits or direct payments by the service recipient to the person providing the goods or services to the terminated service provider, if the provision of such in-kind benefits or direct payments would be treated as reimbursement arrangements if the service provider had paid for such in-kind benefits or such goods or services and received reimbursement from the service recipient .



Disability of Service Provider



Change in Ownership

To qualify as a change in ownership or effective control, the occurrence of the event must be objectively determinable and any requirement that any person certify the occurrence of the change in ownership or effective control must be strictly ministerial.

A change in ownership occurs if a person or group of persons acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of the stock of such corporation.

A change effective control of a corporation occurs if either (a) ownership of stock of the corporation possessing 30% or more of the total voting power of the stock of such corporation or (b) the date a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors before the date of appointment or election.

A change in ownership of a substantial portion of a corporation's assets occurs when any one person, or more than one person acting as a group acquires (or has acquired during 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 of the assets of the corporation immediately before such acquisition or acquisitions.



No Acceleration of Deferred Compensation

An acceleration of deferred compensation violates Code Section 409A unless the acceleration qualifies for an exception provided in the Treasury Regulations

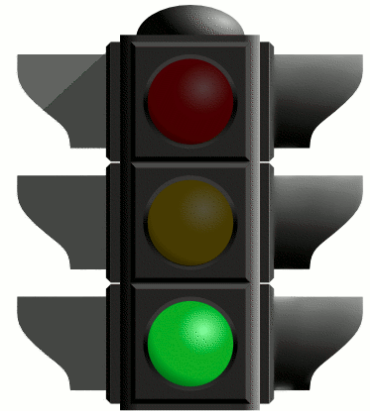
A payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation, including for purposes of the prohibition on accelerated payments.

If a service provider's rights to deferred compensation are subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment or garnishment by creditors of the service provider or provider's beneficiary, such amounts are treated as having been paid to the service provider.

The receipt of a payment of compensation or right to a payment of compensation proximate to the purported forfeiture or voluntary relinquishment of a right to deferred compensation generally is treated as a substituted payment for the payment of the deferred compensation.



409A Endures



409A Doesn't End at Death



Income in Respect of Decedents

- **Individuals (Section 691)**
 - Includes income to which the decedent had a contingent claim at the time of 'his' death
 - Reg.1.691(a)-1(b)(3)
- **S Corporations (Section 1367(b)(4))**
 - Includes income received by S Corporation that would be IRD if received by individual/estate directly
- **Partnerships/LLCs (Section 753)**
 - IRD rules apply to Section 736 payments to deceased partners
 - Case law applies rules similar to the S Corporation rules



Income in Respect of Decedents

Fair market value
of future income
stream included
in estate



Taxed at up to
35% estate
tax rate (2013+?)

No basis
step-up
for IRD
property
for estate or
beneficiaries



No basis step-up for portion
of S Corporation stock,
LLC or partnership
interests attributable to
IRD property



Participations, residuals,
etc., in film and TV
properties -
constitutes IRD



Income in Respect of Decedents

- When IRD income subsequently received, recipient can deduct for income tax purposes a portion of the estate tax attributable to such income
 - Ratio of income received over total IRD income times incremental estate tax on IRD income



Income in Respect of Decedents

Sales v. License of Copyrights

- Income from a license does not result in IRD
 - See PLR 8501006
 - Basis step-up in the copyrights
- Income from installment sale of copyrights results in IRD
 - No basis step-up in future income stream



Graegin Loan

Section 6166 allows an estate to pay estate tax in connection with a closely held business over 14 years rather than 9 months after death.

- Probably not able to take advantage of Section 6166 deferral because income not active and company not closely held



Graegin Loan

- Allows the borrower to deduct the interest that will be paid over the life of the loan on the estate tax return.
- A very powerful way to save an enormous amount of estate tax.
- The lender will want adequate security from the borrower
 - Security may violate the rules of 409A when dealing with deferred compensation



No Sale Allowed As It Would Violate 409A



DISCUSSION



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