

# PRACTICAL 409A



## Specified Employee Status Under Code Section 409A

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*Internal Revenue Code Section 409A introduces new rules governing non-qualified retirement plans and other deferred compensation arrangements. In this series of articles, we take an in-depth look at some of the crucial issues involved with bringing your plans and arrangements into compliance with Section 409A.*

*This article examines the six-month delayed payment rule for “specified employees” under Section 409A. It is extremely important that specified employees be properly identified, and this article—together with the attached Specified Employees Checklist—provides practical guidance to help you comply with this rule.*

Internal Revenue Code Section 409A requires that any deferred compensation payment that is made on account of separation from service to a “specified employee” of a public company be delayed for at least six months following separation from service.

This applies to amounts deferred on and after Jan. 1, 2005. Proposed regulations were issued under Section 409A on Oct. 4, 2005, and final regulations were issued on April 17, 2007. The final regulations generally are effective Dec. 31, 2008, and prior to that date, a plan must be operated in “good faith compliance” with Section 409A and prior guidance issued by the IRS.

### SPECIFIED EMPLOYEE STATUS

Deferred compensation may be paid upon “separation from service,” which generally occurs at the termination of the employment relationship (with special rules for leaves of absence, reduced work schedules, etc.). However, in the case of a “specified employee” of a public company, any payment that is triggered by separation from service must be delayed for at least six months (or until the employee’s earlier death).

**See page 7 for our step-by-step guide to determining specified employee status and a checklist covering several options and variables you’re likely to face.**

Each plan in which a specified employee may or does participate is required to provide in writing for this six-month delay in payment. But apart from simply including a written provision for a six-month delay in payment to a “specified employee,” a deferred compensation plan should also specify the manner in which such delayed payment requirement is to be satisfied.

Relevant issues to consider include:

- **Specific Payment Date.** The plan should indicate clearly the date for payment after the elapse of the six-month period (for instance, the first date after the six-month period has elapsed, the first business day following the expiration of the six months, etc.).
- **How Delay Affects the Payment.** The plan should address whether any payment(s) that would otherwise be due during the first months will be accumulated and paid as of a specified date, or alternatively, whether the date of commencement of payments (such as an installment or annuity payment stream) will simply be pushed back six months.
- **Application of Interest to Delayed Payment.** To



eliminate any uncertainty, the plan should indicate whether any delayed payment(s) will bear interest during the six-month delay period.

The manner in which the six-month delayed payment rule is to be satisfied can be changed by plan amendment, but generally only if the amendment is not made effective until 12 months after it is adopted. (Note the exception in the case of a private company that later becomes a public company; a plan amendment adding the rule or changing the manner in which it applies can be effective immediately if the amendment is made *before* the date on which the company's stock becomes publicly traded.)

### **Public Company Status**

The six-month delayed payment rule applies only to a specified employee of a public company. A company is considered under the regulations to be a public company if any of its stock is traded on an "established securities market." This means, then, that a subsidiary whose parent's stock or stock of an affiliate is traded on an established securities market would be considered a public company for this purpose, and its deferred compensation arrangements (along with the parent's) would be required to contain the six-month delayed payment language.

Under the rules, "established securities markets" generally include:

- National securities exchange registered under Section 6 of the Securities Exchange Act of 1934 (such as the New York, American or Pacific stock exchanges);
- Foreign national securities exchanges that are officially recognized, sanctioned or supervised by a governmental authority (such as the London or Tokyo stock exchanges); and
- Over-the-counter markets reflected by an interdealer quotation system (such as Nasdaq).

It is worth noting, then, that an employee of a U.S. subsidiary of a *foreign* public company is potentially subject to the six-month delayed payment rule.

A private company that later becomes public, either through an initial public offering or by combining with a public company, needs to anticipate including the six-month delayed payment language in any affected deferred compensation arrangements. This language must be reflected in deferred compensation plans and arrangements no later than the date on which the stock of that company is first traded on an established securities market, or if applicable, the date on which it would first be deemed a public company (for instance, the date on which it is acquired by a public company or the subsidiary of a public company).

Whether an employee is employed by a public company is determined at the time of separation from service. This issue of timing may be particularly relevant in the context of a transaction involving both public and non-public entities, where an employee may have a separation from service.

### **DETERMINING SPECIFIED EMPLOYEES**

The final regulations set forth specific provisions about how a public company identifies who is a specified employee for purposes of the six-month delay rule. With respect to certain issues, the company has the ability to make an election that is different from the "default" provided for in the regulations.

We recommend to our publicly held clients that, for the sake of clarity and uniform application to all of their plans, they establish a written "Specified Employees Policy." This policy would set forth the elections the company has made with respect to how specified employees are determined, including the dates for identifying and treating employees as specified employees, and would establish clear guidelines with respect any other issues specific to the company's circumstances that would affect specified employee determinations.

### **Who Is a Specified Employee?**

In general, a "specified employee" is any employee of a public company (as defined above) who satisfies any one

of following conditions:

- Any 5 percent owner;
- Any 1 percent owner with annual compensation of more than \$150,000; or
- Any officer with annual compensation of more than \$145,000 (as adjusted), but limited to a number of employees equal to the lesser of:
  - 50 employees; or
  - The greater of three employees or 10 percent of the employees.

## Compensation

The final regulations define “compensation” for the purpose of identifying specified employees by reference to the definition for compensation contained in Treasury Regulation Section 1.415(c)-2(a) but interpreted as if no safe harbors or special timing rules that otherwise would have been permitted by this section apply. However, employers are permitted to use any alternative definition of compensation permitted under Code Section 415 and its regulations, including any safe harbors or special timing rules, as long as that definition is used consistently across all deferred compensation plans for the purpose of identifying specified employees.

For purposes of identifying specified employees, we believe that the following alternative definitions of “compensation” can be used:

- W-2 Box 1;
  - Wages for purposes of federal income tax withholding; or
  - “Compensation” as defined in Code Section 415(c)(3).
- Each of the core definitions of compensation is slightly different. Some companies may find the simplicity of the W-2 Box 1 definition attractive. However, W-2 Box 1 wages, unlike the default definition of compensation, includes income due to nonqualified stock option exercise or when restricted stock becomes vested. This can create dramatic changes from year to year in compensation levels and which officers rank most highly in terms of compensation.

For U.S. companies with foreign affiliates, the definition of compensation used to identify specified employees may have an important effect on whether their workers outside the United States potentially will be deemed specified employees. This issue is discussed more broadly under “Specified Employees in Context of Organization with Foreign Affiliates” below.

## Identification and Effective Dates

The final regulations require companies to identify a list of specified employees that will remain in effect for a 12-month period. If an employee separates from service during this 12-month period, the employer then refers to this list to determine whether the employee is a specified employee and thus subject to the six-month delayed payment rule.

First, the employer must select a “specified employee *identification* date.” An employee who satisfies any of the specified employee conditions at any time during the 12-month period ending on the specified employee identification date will be considered a specified employee, beginning on the “specified employee *effective* date.”

The specified employee effective date generally occurs approximately three months after the specified employee identification date. For the 12 months beginning with the effective date, all employees who were identified on the “identification date” will be deemed specified employees.

**Default Identification Date.** The “default” identification date under the rules is Dec. 31. The rules allow an employer to designate a different identification date, which the employer must specifically elect.

**Default Effective Date.** The “default” effective date is the first day of the fourth month following the identification date. Therefore, if the identification date is Dec. 31, the default effective date would be April 1. The rules allow an employer specifically to elect a different effective date, but the effective date cannot be later than the first day of the fourth month following the identification date.



## Specified Employee Status for Officers

As discussed above, an employee may be a specified employee because he or she is an officer and has compensation greater than the applicable threshold. However, whether such an officer is a specified employee depends upon the following factors:

- **Definition of “Officer.”** An “officer” is determined by reference to authority and service—not title—and includes any “administrative executive who is in regular and continued service.” Therefore, an employee who does not have the title of officer could nonetheless be an officer for specified employee purposes. Conversely, an employee who holds an officer title may not be an officer under the specified employee rules. In the case of a controlled group of companies, any individual who serves in an officer capacity with any company within the controlled group is an officer.

Officer status on any day within the 12-month period ending on the identification date is enough to be included within the officer group.

- **Limit on Number of Officers.** The limit on number of officers for a controlled group of companies is tied to its total number of employees, using the greatest number of employees during the year. Where a controlled group’s number of officers exceeds the limit, the officers with the greatest compensation during the 12-month period ending on the identification date will be deemed specified employees.
  - *More than 500 employees:* Not more than 50 officers are considered to be specified employees.
  - *Fewer than 500 but more than 30 employees:* The number of officers considered to be specified employees is not more than 10 percent of the number of employees of the controlled group (rounded up to the next whole number).
  - *30 or fewer employees:* Not more than three officers are considered to be specified employees.

## Specified Employee Status in Context of Spin-Off, Merger or Acquisition

**Spin-Off.** If a company is spun off from a public company and the spun-off company, after the spin-off, is a public company, the specified employees continue to have that

status until the next specified employee effective date. The identification date and effective date in effect pre-spin-off continue for both the original company and the spun-off company until changed..

## Merger of Two Public Companies.

For the period from the date of the transaction to the next specified employee effective date of the surviving or acquiring company, the two specified employee lists are combined, and the top 50 officers, ranked by compensation, on the combined list, plus any 1 percent and 5 percent owners who are not also one of the top 50 officers, will be treated as specified employees during that period. The surviving employer’s identification and effective dates will be the applicable dates for the combined entity. When the new specified employee effective date occurs, the list is revised based on the combined entity. Alternatively, the surviving company may elect any other reasonable method for complying with the six-month delayed payment rule, so long as it elects to do so no later than 90 days after the transaction and applies that method prospectively from the date of the transaction.

## Merger or Acquisition Involving a Non-Public Company and a Public Company.

For the period from the date of the transaction to the next specified employee effective date of the surviving or acquiring company, the specified employees of the public company will continue to be specified employees until the next specified employee effective date. No employees of the formerly private company will be specified employees until the next specified employee effective date.

## Specified Employees in Context of Organization with Foreign Affiliates

A multinational corporation having employees in foreign countries as well as in the United States has some ability to determine whether its non-U.S. employees (“nonresident aliens”) are potential specified employees. It may do so by electing a definition of compensation that will result in either more or fewer nonresident aliens (depending upon the definition of compensation elected) meeting the conditions for specified employee status (i.e., officer with compensation in excess of certain threshold levels).

As indicated above, the rules provide a default definition

of compensation for determining specified employee status. But the rules also allow a company to elect any definition of compensation available under Code Section 415(c). The default definition of compensation would include as compensation any income that would normally be excludible from an employee's gross income due to the location of the employer or the services provided being outside the United States. However, an alternative definition of compensation under Code Section 415(c) would permit the employer to *exclude* such compensation from the definition of compensation for determining specified employee status, if the employer so elected.

Depending upon the size and compensation levels of the nonresident alien employee population relative to U.S. workers, an employer's use of the default definition of compensation (which includes wages earned outside the United States) may have the effect of *increasing* the number of offshore employees being deemed specified employees (who, for practical purposes, would not be subject to the six-month delayed payment) and thus decreasing the number of U.S. employees who would be affected by the six-month delay in payment.

For example, if a company ranks its officers by compensation, and includes in compensation income earned outside the United States by its nonresident aliens, the result may be the inclusion of a number of officers outside the United States in the list of specified employees. If such income is excluded from the definition of compensation, however, it is probable that no officers working outside the United States have compensation high enough to place them within the top 50 officers.

Therefore, a publicly held company with operations outside the United States should carefully consider the impact that its choice of compensation definition will have on the composition of its list of specified employees. Although it may be attractive to companies to attempt to restrict the number of U.S. officers potentially subject to the six-month delayed payment rule, doing so carries with it certain administrative burdens. These burdens include identifying which foreign employees come within the definition of "officer" under the regulations, gathering compensation information about those employees, attempting to fit foreign compensation information within the U.S. tax code definitions, converting foreign compensation figures to U.S. currency, and so on.

### **Alternative Method for Satisfying Six-Month Delayed Payment Rule**

An employer is permitted to adopt any other method of satisfying the six-month delayed payment rule, provided that:

- The method is reasonably designed to ensure that all specified employees are identified;
- The method is an objectively determinable standard, providing no direct or indirect election to an employee with respect to its application; and
- The method results in either all service providers or no more than 200 specified employees being identified as of any date.

Some employers may decide to adopt an alternative method—even one where more employees will be treated as specified employees, and thus subject to the six-month payment delay—to ease administrative burdens.

For instance, an employer may decide to treat all employees as specified employees to avoid the possible underinclusion of specified employees. Another may determine that all employees in certain pay grades and above will be deemed specified employees. This approach is permitted under the rules, as long as it will capture all specified employees and the number of specified employees does not exceed 200.

### **ENSURING EFFECTIVENESS OF ELECTIONS FOR SPECIFIED EMPLOYEE STATUS**

A company that chooses to make one or more of the elections permitted by the regulations with respect to specified employee identification should be mindful that those elections are effective only as of the date that *all necessary corporate action* has been taken to make the elections binding for purposes of *all affected nonqualified deferred compensation plans* in which the service providers who would become specified employees, as a result of such election(s), participate. These elections would relate to any of the following:

- The definition of compensation used for determining specified employees other than the default definition;
- A specified employee identification date other than the default date;

- A specified employee effective date other than the default date;
- Any alternative method adopted for determining specified employees; and
- In connection with a merger of two public companies, an initial public offering or other corporate transaction: an alternative specified employee identification date, alternative specified employee effective date or alternative method for determining specified employees.

“Necessary corporate action” would include the written designation of any such election; compliance with any procedures for plan amendments provided for in any affected plan; and obtaining any required approvals or consents, such as the consent of the compensation committee or the board of directors, the chief executive officer or a party to whom administration authority has been delegated.

**IMPORTANT:** Failure to make effective elections may result in severe consequences. If any election is not binding on all the affected nonqualified deferred compensation plans and applied consistently with respect to all employees who would become specified employees,

the election will not be considered effective. In that case, the defaults provided for in the regulations would apply. Therefore, special care needs to be taken in making any elections as alternatives to the defaults provided for in the regulations. Specifically, an employer should:

- Identify all existing affected deferred compensation plans and arrangements;
- Reflect in writing in each existing plan, either by incorporation of the company’s specified employee policy by reference or by including a specific provision in the plan, the company’s alternative election;
- Document full compliance with all corporate and plan governance procedures required to make the election effective as to each individual plan (it is better to be too cautious here than not cautious enough); and
- With respect to plans adopted in the future, make sure that the foregoing steps have been taken.

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# STEPS FOR DETERMINING “SPECIFIED EMPLOYEE” STATUS UNDER SECTION 409A

1. Make your decisions with respect to the variables that apply to determine specified employee status, including:
  - The definition of “compensation” that you will use;
  - How you will handle the compensation paid to your nonresident alien employees;
  - How you will determine your officers
  - What measuring period you will use (or what your “specified employee identification date” will be); and
  - What effective date will apply to your determination (this is called the “specified employee effective date”).
2. Make sure the decisions are documented in a separate “Specified Employees Policy” or are documented in each plan or agreement where specified employee rules are relevant. (If you do not document your decisions appropriately, you must use the “default” rules set out in the regulations under Section 409A.)
3. Gather the necessary data.
4. Rank your officers by compensation and identify the maximum number of officers that are considered specified employees.
5. This new list will become effective as of your specified employee effective date.
6. Save your work in the event it becomes necessary to demonstrate your specified employee process.

# SPECIFIED EMPLOYEES CHECKLIST

Use this checklist to guide you through the choices you will need to make regarding specified employees among the variables set out in the regulations under Section 409A. In some cases, we provide recommendations to help you along the way.

## Variables necessary to determine “specified employees” under Section 409A of the Internal Revenue Code

### COMPENSATION

You have various options for defining the compensation that you will consider in identifying your specified employees. There are two core definitions of compensation you can use, with the most significant difference being whether equity compensation amounts (restricted stock vesting and nonqualified stock option exercises) are included in compensation. There are other differences between the definitions, but the differences are less significant. (Within each core definition, there are two alternative definitions that very likely would not have an impact on the specified employee determination.)

We wish to use ...

- ☐ A definition that excludes income recognized upon vesting of restricted stock or exercise of a non-qualified stock option from compensation.
- ☐ A definition that includes income recognized upon vesting of restricted stock or exercise of a non-qualified stock option in compensation—specifically, we wish to use ...
  - ☐ W-2 pay
  - ☐ Withholding pay

Compensation always includes amounts excluded from income as a result of an election under a cafeteria plan, qualified transportation fringe benefit or qualified plan.

The definition of compensation can be changed, but it cannot be changed once the specified employee group becomes effective.

(The “default” is the definition that excludes income recognized upon vesting of restricted stock or exercise of a non-qualified stock option from compensation.)

**Recommendation:** The definition that excludes income recognized upon vesting of restricted stock or exercise of nonqualified stock options leads to a more stable list of specified employees from year to year because stock option exercises and restricted stock vesting do not impact the determination. However, a W-2 definition is easier to obtain. Thus, there is a tradeoff between stability and ease of administration.



**IDENTIFICATION  
DATE (OR  
MEASURING  
PERIOD)**

You may choose the 12-month period over which compensation is measured for purposes of determining your specified employees. This can be any period you select that applies uniformly for all nonqualified deferred compensation plans.

Our measuring period is the ...

☐ Calendar year

☐ 12-month period ending \_\_\_\_\_

The last day of the measuring period is referred to as the “specified employee identification date.”

The measuring period can be changed but the change cannot be effective for a period of at least one year.

(The “default” measuring period is the calendar year.)

**Recommendation:** Use calendar year unless there is a compelling reason to do otherwise.

**EFFECTIVE DATE**

A specified employee continues in that status for a full year, and then a new specified employee group comes into place. While many specified employees may carry over from one year to the next, some employees may drop off the specified employee list and others may be added to the specified employee list. The new specified employee group comes into place as of the first day of the month following the specified employee identification date. (For example, if the identification date is Dec. 31, the new group comes into place the following April 1.) You can elect a different effect date.

Our specified employee effective date is ...

☐ The first day of the fourth month following the specified employee identification date

☐ Other: \_\_\_\_\_

(The “default” specified employee effective date is the first day of the fourth month following the specified employee identification date.)

**Recommendation:** Use the first day of the fourth month following the identification date unless there is a compelling reason to do otherwise.

**NONRESIDENT  
ALIEN EMPLOYEES  
ELECTION**

In the case of a nonresident alien, you may choose to include or exclude compensation that is excludable from gross income in the U.S. and that is not effectively connected with the conduct of a trade or business in the U.S. (generally, compensation for services rendered outside the U.S.). Including foreign compensation earned by nonresident aliens may result in certain nonresident alien employees being considered “specified employees,” and thus reducing the total number of employees subject to the six-month delayed payment rule. However, including foreign compensation earned by nonresident aliens may add administrative complexity.

We wish to ...

☐ include

☐ exclude

... foreign compensation earned by nonresident alien employees.

The foreign employee elections can be changed, but cannot be changed once the specified employee group becomes effective. (The “default” is that foreign compensation is included.)

**Recommendation:** There is a tradeoff between ease of administration and limiting the number of employees who are affected by the six-month delayed payment rule. Including foreign compensation earned by nonresident alien employees may result in some specified employees being foreign workers not covered by deferred compensation—thus, the group affected by the six-month delay is limited. However, foreign compensation needs to be converted to U.S. dollars and tracked in a way that may be difficult from an administrative standpoint.

**OFFICERS**

It is necessary to identify your “officers,” which are not determined by title necessarily, but are defined as any “administrative executive who is in regular and continued service.”

We will determine officers as follows:

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**ALTERNATIVE  
METHOD OF  
COMPLIANCE**

You can use an alternative method of identifying service providers if the alternative method is reasonably designed to include all specified employees (determined under the normal rule), is objective and results in no more than 200 employees (or all employees) being treated as specified employees as of a given date.