



# Section 409A: Expert Advice on Avoiding Common Pitfalls

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Presented by

PRACTICAL LAW COMPANY

and

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# SECTION 409A BACKGROUND



## Section 409A Background

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- **Section 409A has brought about fundamental changes in the way executive compensation arrangements are negotiated and drafted**
  - Far-reaching, *e.g.*, covers many severance arrangements and equity-based awards
  - Complex regulatory scheme imposes rigid payment timing restrictions on deferred compensation arrangements
- **Raises complex and uncertain issues related to drafting and treatment of payments under deferred compensation arrangements**
- **Exposes companies' compensation practices to audit by the IRS**



# Penalties

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## ➤ Effect of failure to comply with Section 409A

- Service provider is required to include in income – and pay 20% surtax and interest on – amounts deferred under an arrangement that violates Section 409A, in the year in which a violation occurs (but not for prior or subsequent years in which a violation does not occur)
  - Income inclusion may be triggered on plan aggregation basis for all vested amounts
- No direct consequences to the service recipient (employer), although reporting and withholding obligations apply



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# COMMON SECTION 409A PITFALLS



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# Identifying Deferred Compensation



# Identifying Deferred Compensation

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- **Examples of nonqualified deferred compensation subject to Section 409A**
  - Supplemental retirement and deferred compensation plans and programs
  - Many employment, change in control and severance agreements, plans and arrangements
  - Phantom stock, deferred shares and restricted stock units, if not payable under any circumstances within short-term deferral period – often because of retirement or other termination provisions, including “continued vesting” following termination subject to compliance with a non-compete
  
- **Examples of amounts not treated as nonqualified deferred compensation**
  - Partnership interests, including profits interests
  - Restricted stock
  - Stock options (including ISOs) or stock appreciation rights, if granted on “service recipient stock” with an exercise price that may never be less than fair market value as of the date of grant
  - Qualified plans
  - Payroll practices, vacation, sick pay, COBRA premiums
  - Compensation that was earned and vested (*i.e.*, no longer subject to a substantial risk of forfeiture) as of December 31, 2004 (so long as plan is not materially modified)





## Identifying Deferred Compensation (cont'd)

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- A payment is generally subject to Section 409A if there is a legally binding right to compensation that vests in one year and pays in another, unless a specific exception applies. Compensation arrangements to pay particular attention to include:
  - Traditional deferred compensation/other non-qualified retirement benefits
  - Severance paid over time
  - Severance payable on a broad termination for good reason
  - Phantom equity awards vesting and payment terms



**Remember plan aggregation**



**Section 409A applies to both private and public companies and to all service providers (employees, directors, and many independent contractors)**



**The ability to change the timing of payment of compensation is limited, whether or not the compensation is subject to Section 409A**

- Compensation subject to Section 409A: Subject to certain limited accelerations and deferrals; cannot accelerate or delay the timing of payment
- Short-term deferrals: Can accelerate but generally cannot delay timing of payment



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# Timing of Initial Deferral Elections



## Timing of Initial Deferral Elections

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- **Deferral elections are generally required before the start of the year in which the compensation is earned**
    - Deferral elections must be in writing and irrevocable
    - Election form must specify a permissible time of payment
  
  - **Most Common Exceptions:**
    - Performance-based Compensation – Must be made no later than 6 months prior to the end of the performance period, which must be at least 12 months long, and before the compensation is reasonably ascertainable
      - For the performance-based exception to be available, (i) performance period must be 12 months or more, and (ii) payment must be contingent on the satisfaction of pre-established organizational or individual performance criteria set forth within 90 days after the start of the performance period.
    - New employees/directors – Must generally make deferral elections within 30 days of the first day the individual is eligible to participate in a new arrangement
      - “New hire” exception applies the first time an individual is eligible to participate in a plan. It is available only if director/employee is not eligible to participate in other aggregated plans and is only for the portion of compensation attributable to services performed after the election is made (including the prorated portion of the bonus only).
    - “13 month rule” – Election may be made within 30 days of the first day employee has a legally binding right if the election is made at least 12 months prior to the earliest date on which the compensation may become vested
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# Supplemental Executive Retirement Plans (SERPs): Linked Plan Issues



## SERPS – Linked Plans

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- **Nonqualified plans may be “linked” to qualified plans or other nonqualified plans**
- **Plan offset provisions (resulting in a shift of benefits under the plans) can result in a deemed new deferral election or an acceleration in violation of Section 409A, unless:**
  - the change in the deferred amount under the nonqualified plan results from the operation of the qualified plan or a foreign broad-based plan
  - there is no resulting change in the time or the form of payments under the nonqualified plan; and
  - the change in the amount deferred under the nonqualified plan does not exceed the change in the amount deferred under the qualified plan.
- **A nonqualified plan “linked” to another nonqualified plan will result in a documentary violation of Section 409A unless the payment triggers and all forms of payment under the two plans are identical.**



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# Inadvertently Subjecting Restricted Stock Units (RSUs) to Section 409A



## Inadvertently Subjecting RSUs to Section 409A

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- Of the common equity arrangements, RSUs are the most likely to be subject to Section 409A
- An RSU that appears to be excluded from Section 409A because it generally pays upon vesting may in fact be subject to Section 409A if:
  - Vesting accelerates on retirement or upon termination for non-compliant good reason
  - Vesting continues following retirement or other termination, including during a post-termination non-compete period
- ⚠ Provisions causing RSUs to be subject to Section 409A are often found in documents other than the award agreement (*e.g.*, employment, severance, and change in control agreements)



## Inadvertently Subjecting RSUs to Section 409A (cont'd)

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### RSUs subject to Section 409A

- An RSU that is subject to Section 409A must have a fixed payment date and otherwise comply with Section 409A's requirements
- There is less flexibility to amend the terms of an RSU subject to Section 409A
- An RSU subject to Section 409A generally cannot have payment accelerated (but vesting may be accelerated)
- An RSU subject to Section 409A that is held by a specified employee and that may be payable on separation from service, must provide for a 6-month delay for payment upon separation





## Inadvertently Subjecting RSUs to Section 409A (cont'd)

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### Avoid RSUs being subject to Section 409A

- Provide for vesting only on involuntary termination of employment (including Section 409A-compliant good reason terminations)
- Eliminate vesting on retirement or provide for payment on retirement eligibility
- Provide for clawback on non-compliance with restrictive covenants (rather than continued vesting during restricted periods)



## Inadvertently Subjecting RSUs to Section 409A (cont'd)

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Alternatively, structure the RSU to comply with Section 409A:

- Provide for fixed payment date
- Ensure there is no accelerated payment on impermissible events
- Provide for payment only on a Section 409A-compliant change in control
- Provide for 6-month delay, if applicable



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# Stock Right Awards



# Stock Right Awards

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## Exemption for stock options and stock appreciation rights

- Exercise price can never be less than 100% of FMV of the stock on grant date
- Cannot include a deferral feature
- Must be granted on service recipient stock – generally, common stock of employer or parent

## Alternatively, structure stock awards to be compliant with Section 409A

- Payment timing must comply with Section 409A
  - Fixed date
  - Change in control
- Greater flexibility to settle over time



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# Separation From Service



# Separation From Service

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**Separation from service is a permissible payment event under Section 409A**

## **Separation from service determinations for employees and independent contractors**

### ➤ **Employees**

- Default rules: Separation from service occurs when there is a reduction in services of at least 80%
- Plans may provide for a different threshold for separation from service between a 50% and 80% service reduction
- Determinations are based on reasonable expectations of future services

### ➤ **Independent Contractors or Directors**

- Separation from service occurs upon complete termination of the contractual relationship



## Separation From Service (cont'd)

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### Erroneous determinations of separations from service may result in Section 409A violations

- **Failure to recognize a separation from service has occurred (impermissible deferral)**
  - Leaves of absence longer than 6 months (other than due to disability) generally must be treated as a separation from service
  - In cases of a qualifying disability, an employee on leave must be treated as separated after 29 months
- **Treating an inadequate service reduction as a separation from service under Section 409A (impermissible acceleration)**
  - An employee who terminates employment but continues to provide the same level of services to the company as a consultant does not incur a separation from service



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## “Good Reason” Terminations





## “Good Reason” Terminations

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- Qualifying “good reason” terminations by the employee are treated as “involuntary separations” for purposes of certain exceptions under Section 409A
  - Short-term deferral
  - Separation pay plan
- When is “good reason” an “involuntary separation”?
  - Requires a material change in terms and conditions of employment
  - Section 409A regulations contain a safe harbor definition; all other definitions are based on facts and circumstances
  - Include provisions requiring employee notice/employer opportunity to cure
  - Substantially identical amount, time and form of payment as on an involuntary separation (*e.g.*, termination without cause)



## “Good Reason” Terminations (cont’d)

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### ➤ Safe harbor “good reason”

- Material reduction in (i) base salary, (ii) authority, duties or responsibilities or (iii) budget authority
- Material change in geographic work location
- Material breach of an employment agreement
- Notice to employer within 90 days of initial existence of “good reason”
- Employer has 30 days to cure the circumstance constituting “good reason”
- Termination must occur within 2 years of initial existence of “good reason”
- Substantially identical amount, time and form of payment as other involuntary separations

### ➤ “Good Reason” outside of the safe harbor: Open Issues

- Lack of a materiality threshold in one or more triggers
- Notice/cure periods less than the safe harbor time periods
- Variances in the amounts or benefits payable in a “good reason” separation as compared with other involuntary separations



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# Avoiding Impermissible “Toggling”



## Avoiding Impermissible “Toggling”

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- **Under Section 409A, subject to certain exceptions, payments must have one possible payment schedule for any single payment event**
  - For example, a payment that is made on various types of separations from service must generally be paid on the same schedule following each type of separation
  
- **Deferred compensation, including RSUs and severance arrangements that are subject to Section 409A, must comply with this anti-toggling rule**



## Avoiding Impermissible “Toggling” (cont’d)

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- **Design the arrangement so it is not subject to Section 409A**
- **Know the exceptions to the anti-toggling rule**
  - Termination within 2 years following a Section 409A change in control
  - Termination following specified age, service, or age and service
  - Prior to or following a single fixed date
  - JCEB: Ok to accelerate payment on a subset of a permitted payment event
- **Provide for one schedule of payments for a single payment event**
- **Different payment events (*i.e.*, death, disability, change in control) may provide for different payment schedules**



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# Releases



## Releases

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- **Employment or severance agreements providing that payment will not be made until an employee signs and fails to revoke a release of claims must be reviewed for Section 409A compliance**
  - The possibility that the employee could delay signing the release could be viewed as causing the payment to become subject to Section 409A and violate Section 409A, or could be viewed as permitting impermissible payment delay if payment is subject to Section 409A
  
- **Where the payment is intended to be a short-term deferral (*i.e.* it always pays on vesting), specify the maximum number of days the employee has to execute (and not revoke) the release**
  - Amounts may be paid upon execution of the release
  - Amounts are forfeited if the release is not executed within the specified number of days
  - The sum of the number of days the employee has to execute (and not revoke) the release and the number of days following which the payment is made should not extend past March 15 of subsequent year



## Releases (cont'd)

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- **Where the payment is subject to Section 409A, specify the date on which the payment will be made (*i.e.*, 60 days following termination of employment)**
  - Amounts forfeited if release is not irrevocable by specified date
  - Amounts may be paid 30 days before specified date or until the end of the year of the specified date
  
- **Where the payment is subject to Section 409A, alternatively, specify the period during which payment will be made (*e.g.*, within 60 days following termination of employment) but specify that, where the period spans year-end, payment will always be made in the later year**

Note: In certain circumstances, amounts may be delayed if the payment of the amount is in dispute or would jeopardize the ability of the company to continue as a going concern





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# International Section 409A Issues



## International Section 409A Issues

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- Section 409A has broad extraterritorial reach
- Section 409A affects U.S. citizens and green card holders working outside of the U.S., as well as U.S. residents
- U.S. citizens and permanent residents (*i.e.*, green card holders) are subject to tax on their worldwide income regardless of residency
- Identification of U.S. Taxpayers
  - Employers do not always know which employees are subject to taxation in the U.S.
- Exemption for certain deferred compensation arrangements
  - (i) tax equalization agreements (subject to limitations); (ii) certain foreign separation pay plans; (iii) broad-based foreign retirement plans; and (iv) compensation deferred by a nonresident alien if such compensation would not have been subject to U.S. income tax if it had been paid to the nonresident alien at the time that either the legally binding right to the compensation first arose or, when the legally binding right was no longer subject to a substantial risk of forfeiture



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# CONCLUSION - RECOMMENDATIONS



## Internal Coordination

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- **Establish a Section 409A team – HR, legal, tax, payroll**
- **Establish parameters regarding what can be adopted before consulting with the Section 409A team**
- **Consult the Section 409A team before making modifications to existing compensation arrangements**
- **Perform internal audits before year-end to identify any violations**
  - Much more likely that a violation will be able to be corrected if caught quickly



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## SECTION 409A AUDITS



## Section 409A Audits

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### State of Section 409A Audits

- Some companies undergoing audits have received Information Document Requests (IDRs) from the IRS asking for details of pay practices that may be subject to Section 409A
- The level of technical sophistication in Section 409A audits still unclear



## Section 409A Audits

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### Self-Audits

- **Between the time of Section 409A's adoption in 2005 and the end of the transition period on 12/31/08, many companies engaged outside counsel to review their benefit plans for Section 409A compliance; however,**
  - We are still finding clients who have either never heard of Section 409A or only had their outside counsel look at traditional deferred compensation arrangements
  - For companies who did have a full review of company plans and agreements done prior to 2008, a follow-up review may be warranted:
    - new arrangements may have been adopted
    - additional guidance released by the IRS and informal discussions on what they view to be documentary and operational violations
  - Best practices have evolved
  - Many companies – including very sophisticated ones – are still struggling with Section 409A compliance
  
- **If issues are identified, formal corrections programs may be available. In addition, there may be other opportunities to correct without incurring penalties**



## Special Considerations

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- Although most Section 409A violations result from actions by the company, the tax penalties for violations of Section 409A are imposed on the employee
- Involve re-filing of individual employee and director returns – company can't just pay a penalty and fix it. Section 409A gross-ups may be an option but are often very expensive and are also viewed as poor pay practices for public companies
- It is unclear whether an employee could successfully sue an employer for reimbursement for additional taxes caused by a Section 409A failure, but a Section 409A failure will, at a minimum, strain the relationship between the company and the affected employees





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Regina Olshan is a partner in the Executive Compensation and Benefits practice group at Skadden, Arps, Slate, Meagher & Flom LLP. Ms. Olshan's practice focuses on advising companies, executives and boards on navigating the regulatory complexities of executive compensation and benefits. This includes tax laws (including laws governing deferred compensation, golden parachute arrangements and deduction limitation rules), securities laws (including reporting and disclosure requirements and registration issues) and limitations imposed on companies that have accepted money under TARP.

Ms. Olshan is the author and editor of the *Section 409A Handbook*, lectures frequently on executive compensation issues, and has been quoted in various major publications on issues arising under Internal Revenue Code Sections 409A and 457A, and other executive compensation matters.

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Prior to joining Morgan Lewis, Mr. Hogans was an attorney advisor in the Office of Benefits Tax Counsel at the U.S. Department of the Treasury. In this role, he served as an advisor to senior Treasury officials and Congressional staff on both legislative and regulatory matters relating to employee benefits and executive compensation. Mr. Hogans also served as the leading Treasury representative in the development of regulations and other guidance governing the federal tax treatment of equity and deferred compensation arrangements of corporations and partnerships, including regulations under Section 409A. While at Treasury, Mr. Hogans was deeply involved in regulations and other guidance affecting ESOPs, including regulations governing ESOP interests in subchapter S Corporations. Before joining the Treasury Department, Mr. Hogans was in private practice for 10 years.

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## Section 409A Resources at [www.practicallaw.com](http://www.practicallaw.com)

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- PLC's comprehensive [Internal Revenue Code Section 409A Toolkit](#) includes resources such as:
  - [Section 409A: Deferred Compensation Tax Rules: Overview](#)
  - [Correcting Errors under Section 409A](#)
  - [Nonqualified Deferred Compensation Plan](#)
  - [Model Section 409A Employment Agreement Provisions](#)
  - [Determining Specified Employees under Section 409A Checklist](#)
  - [Deferral Election Deadlines under Section 409A Chart](#)
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