Demystifying Section 409A: 5 Common Situations the Benefits Department Must Be Prepared to Handle

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Dedicated to my best friend, Jennifer Falk, who married the kind of guy who writes a book about Section 409A.
Agenda

- High-Level Review of Section 409A
  - Scope
  - General Rules
  - Penalties
- Five Situations Commonly Arising for Benefits Departments
  - Bonus Plans (Annual or Long-Term)
  - Severance
  - Equity Compensation
  - Employment Agreements
  - Mergers and Acquisitions
- Corrections/Violations
- Best Practices
- Q&A
Review of Section 409A

- Section 409A is intended to force taxpayers to say exactly “when” future compensation will be paid
  - Gov’t felt ability to manipulate timing was abusive
- Promise today———→ Pay later: When?
  - Calendar year
  - Other events—defined in exhaustive detail
    - “Change in Control”
    - “Separation from Service”
    - “Unforeseeable Emergency”
    - “Disability”
    - Death—(not defined)
Section 409A applies to “deferred compensation”

Scope of deferred compensation is very broad
○ Potentially any arrangement that promises compensation in a future year, such as:
  • Salary for employee over the next three years
  • Transaction bonus to consultant if Company is sold
  • Stock options for director exercisable in the future
  • Severance payable upon termination
Need to develop the 409A mindset
  ◦ “This arrangement promises future compensation, so it may be subject to 409A. Let’s determine if it’s exempt. If not, it must comply with all of 409A.”

For most companies, Section 409A issues arise in
  ◦ Employment agreements
  ◦ Severance agreements
  ◦ Equity and long-term incentive plans (bonus)
  ◦ Nonqualified deferred compensation (top hat) plans
If Section 409A Applies...

- May/must be paid only upon permissible payment triggers
  - Specified date
  - Death
  - “Disability”
  - “Unforeseeable Emergency”
  - “Change in Control Event”
    - Note: IPO doesn’t qualify
  - “Separation from Service”
    - Thresholds to prevent manipulation
    - 6-month wait for top employees of public companies where separation from service is the trigger
If Section 409A Applies… (cont.)

- Arrangement must state the time (trigger) and form of payment
  - If participant may designate amount, time or form of benefit, the election must be made by certain deadlines
- Once form and trigger are identified, the compensation generally cannot be accelerated or further deferred
If an arrangement violates Section 409A (in form or operation):
- Participant, not the Company, is subject to
  - Immediate income tax to the extent vested
  - 20% penalty plus other underpayment penalties
- Company is subject to
  - Potential reporting/widholding failures
  - Egg on face?

Some correction methods are available
- As discussed later...
Exemptions from Section 409A

- Qualified Plans
- Certain stock rights (options/SARs)
  - No discount; common stock of service recipient or higher
- Certain severance pay
  - Meets conditions and up to certain limits
- “Short-Term Deferrals”
  - Pay-when-vest arrangements
    - “Pay” really by March 15 of calendar year following year of vesting
    - “Vest” must be a substantial risk of forfeiture
Exemptions—“Short-Term Deferral”

- **Example: Retention Bonus**
  - Pay $10,000 if you remain employed through August 31 of Year 1
  - Requires continued service
  - Pays when vested—deadline really March 15 of Year 2

- **Example: Event Bonus**
  - Pay $10,000 if Company sells next year for at least $1 billion
  - Requires event related to compensation
  - Must be “substantial” risk of forfeiture

- **Promise**
  - [Vest and Pay]
Exemptions—“Short-Term Deferral” (cont.)

- But…
  - If vest in one year and may be paid in later year, then it is not a short-term deferral.

- Example: Vested Promise to Pay
  - If you work here through December 31 of Year 1, we will pay you $10,000 on June 30 of Year 5.

- Promise———→Vest—→Pay
  - Subject to 409A
    - Can “pay” only upon a 409A permissible payment trigger.
Exemptions—“Short-Term Deferral” (cont.)

- **Substantial Risk of Forfeiture—Facts and circumstances**
  - Pays only if EE continues employment through [anything]
    - Yes, doesn’t vest until [anything]—STD
  - Even if EE stops working, pays only upon transaction at least $X or performance of at least Y.
    - Maybe
  - Pays upon transaction/IPO occur at any level
    - Maybe
  - Pays only upon firing/death/disability/“Good Reason”
    - Yes, doesn’t vest until termination
  - Pays upon any termination, even voluntary quit
    - No SRF, it’s vested—must comply with Section 409A
    - What about “retirement” or easy “good reason”? 
Section 409A is alive and in effect
Violations (form or operation) trigger full wrath of Section 409A penalties unless corrected under applicable guidance
Section 409A penalties calculated pursuant to proposed regulations
  Still awaiting final regulations
Game Reset—You are Here (cont.)

- Section 409A experts among least popular
- Documents are longer with many technical provisions meaningless to lay people
- Uncertainty regarding gray areas and likelihood of enforcement/discovery
- Bogeyman (so far) isn’t the IRS, it’s counterpart in corporate transactions
Five Common Situations

1. **Bonus Plans (Annual or Long-Term)**
2. Severance
3. Equity Compensation
4. Employment Agreements
5. Mergers and Acquisitions
1. Bonus Plans

- Includes a variety of incentive compensation agreements
  - Annual bonus
  - Long-term bonus (e.g., 3-year performance cycle)
  - Phantom equity
  - Transaction bonuses
  - Retention bonuses
1. Bonus Plans (cont.)

- Primary Issue—Is bonus exempt from 409A as a short-term deferral (pay-when-vest) or must it comply with 409A?
  - If exempt, need not meet 409A definitions
    - Example: Bonus paid if work through IPO
  - If exempt, can choose to accelerate vesting
    - Example: IPO becomes unlikely, choose to pay IPO bonus anyway on random Tuesday
  - But…
  - If subject to 409A, must pay upon permissible trigger
    - “change in control”/“separation from service”/specified date
  - If subject to 409A, can’t accelerate distribution
1. Bonus Plans (cont.)

- Short-term deferrals
  - Exempt by requiring continued employment
    - Retention bonus
      - Example: $10,000 if work through June 30, pay immediately
    - Transaction bonus
      - Example: $10,000 if work through sale, pay upon sale
    - Annual bonus
      - Require continued employment through payment date?
      - Earned on last day of performance period?
        - If yes, payable when?
          - By March 15?
          - If may be later than March 15, not an STD so must identify the calendar year to comply.
1. Bonus Plans (cont.)

- Short-term deferrals
  - Exempt by requiring performance level—even for former/non-employees
  - Facts and circumstances
    - Example: Transaction bonus—sale of least $X
1. Bonus Plans (cont.)

- **Common wrinkles**
  - “Retirement”
    - Likely vested, must comply with 409A
    - Pay upon permissible trigger, such as:
      - Separation from service (6-month wait?)
      - Change in control
      - Specified date (end of performance period)
  - Pro-rated upon death/disability/firing
    - If paid upon vest (termination), still exempt as STD
    - If delayed, must comply with 409A and pay upon permissible trigger
Five Common Situations

1. Bonus Plans (Annual or Long-Term)
2. Severance
3. Equity Compensation
4. Employment Agreements
5. Mergers and Acquisitions
2. Severance

Generally promised under
• Employment Agreements
• Change in Control Agreements
• Severance Plans

Often, no pre-existing promise—just a new agreement between employer and employee.
2. Severance (cont.)

- Two big exceptions to consider
  1. Short-term deferral exception (pay upon vesting)
     - Example: Upon involuntary termination, company will immediately pay public company CEO $1 million in lump sum
  2. Separation Pay exception (limited $ and duration)
     - Section 409A does not apply to the extent payments (i) do not exceed dollar limit, and (ii) are paid within limited time period
     - Dollar limit is 2 times lesser of 401(a)(17) limit ($265k for 2015) or individual’s rate of compensation (generally in prior year)
     - Time limit is by the end of the second calendar year after the year in which employment terminated
2. Severance (cont.)

- Key Question: Is the separation pay vested?
  - If payable only upon an involuntary termination (or Good Reason), not vested
    - May still have 409A short-term deferral exception
    - May meet Separation Pay (2-times) exception
  - If payable upon a voluntary termination (or easy good reason), it is vested and neither exception can apply—must comply with 409A rules (including 6-month wait)
2. Severance (cont.)

“Stacking” of Separation Exceptions

- When designing a severance package, remember that you can use multiple exceptions
  - Short-term deferral exception (2.5 month rule)
  - Separation pay exception (2x and 2-year)
  - Others beyond scope of this presentation
Severance Example 1:

- Public company CEO who makes $1 million per year has a severance package that immediately pays her $5 million in a lump sum, but she will get the $5 million no matter when or why she terminates employment (fire, quit, death, etc.)
  - Is it subject to 409A? What’s the effect?
Severance Example 1:

- **Answer:** Yes, it is subject to 409A
  - She was “vested” because she gets the $5 million even upon a quit, therefore we cannot use the short-term deferral or the separation (2x) exception.
- **Result:**
  - The severance package is subject to Section 409A
  - Payment must be made on 409A “separation from service”
  - Because it’s a public company, she is a specified employee and must wait 6 months to receive the $5 million
Severance Example 2:

- Public company CEO has a severance package that immediately pays her $5 million in a lump sum, but NOW she will get the $5 million only if she is terminated involuntarily (remember, this means fired or quits pursuant to valid good reason threshold)
  - Is it subject to 409A? What’s the effect?
Severance Example 2:

- Answer: It is NOT subject to 409A because it is exempt as a “short-term deferral” (pays out no later than 2.5 months after year of vesting)
  - Can pay entire $5 million immediately
Severance Example 3:

- Public company CEO has a severance package that is payable only upon an involuntary termination. The package includes:
  - $5 million lump sum paid immediately
  - $500,000 paid 4 months after termination
  - $500,000 paid 5 months after termination

- Is it subject to 409A? What’s the effect?
- Assume she is fired on December 24th. . .
Yes, in part

- $5 million lump sum paid immediately
  - Exempt as short-term deferral
- $500,000 paid 4 months after termination
  - Not a short-term deferral, but we can still exempt the first $530,000 (2x lesser of 401(a)(17) limit or compensation) paid before end of 2nd year
  - All of this exempt
- $500,000 paid 5 months after termination
  - Not a short term-deferral, but still have $30,000 left in separation pay exception
  - The remaining $470,000 is subject to 409A and cannot be paid until she’s been terminated for 6 months.
Severance—The Release Trap

“Executive will receive a severance package of [X] commencing when she turns in a valid release of all claims against the company.”

- IRS fears executive will sit on release to time her income recognition
- This is a condition that may occur OUTSIDE the short-term deferral period and the 2-year period, so neither exception applies
- You now have deferred compensation that must comply—(e.g., pay on the 90th day)

Design by requiring the release no later than the STD period and you can still use both exceptions.
Five Common Situations

1. Bonus Plans (Annual or Long-Term)
2. Severance
3. **Equity Compensation**
4. Employment Agreements
5. Mergers and Acquisitions
3. Equity Compensation

- Much of executive compensation is paid or measured not in cash, but in stock
- The most common forms of equity compensation are:
  - Restricted Stock
  - Stock Options
  - Stock Appreciation Rights
  - Restricted Stock Units
  - Phantom Stock
3. Equity Compensation (cont.)

- **Restricted Stock**
  - Current transfer of stock subject to vesting
  - Taxed under Sec 83 (later of transfer/vest), which in spirit is similar to the short-term deferral rule
  - Generally NOT subject to 409A

- **Restricted Stock Units**
  - Unsecured promise to transfer property (a share) in the future
  - Generally is subject to 409A, but can be exempt if designed to be a short-term deferral
    - **409A RSU**: RSU vests in Year 2 and share distributed upon earlier of Year 5 or separation from service
    - **Exempt RSU**: RSU vests and share distributed simultaneously
3. Equity Compensation (cont.)

- Phantom Stock
  - Unsecured promise to transfer cash (usually) in the future based on stock value
  - Generally is subject to 409A, but can be exempt if designed to be a short-term deferral
    - 409A Phantom: Award fully vested at grant and pays upon earliest of (i) separation from service, (ii) change in control or (iii) Year 10.
    - Exempt Phantom: Award vests and cash distributed simultaneously
3. Equity Compensation (cont.)

- Stock Options
  - Right to purchase stock at fixed price during exercise period
  - Compensation is equal to the “spread” (difference between value at time of exercise less exercise price)

- Stock Appreciation Rights (SARs)
  - Right to receive cash or stock with value equal to the spread at time of exercise
  - No need to tender any exercise price

- Section 409A refers to options and SARs as “Stock Rights”

- Stock Rights not taxable until exercised, thus potential for abuse by issuing discounted options
  - “Pay me $1 less and issue me an option that is discounted by $1, thereby baking into the option my $1 of deferred compensation until I choose to exercise.”
3. Equity Compensation (cont.)

- But options holders, particularly at public companies, generally would not want exercise to be restricted to 409A triggers... unless they had a crystal ball.
- So gov’t gives a “stock right” exemption for certain stock options.
  - If stock right meets the exemption, it can be exercised at any time during the option term.
  - If stock right is subject to 409A, then award must be tied only to permissible payment triggers.
3. Equity Compensation (cont.)

- "Stock Right" exception: A stock option/SAR will be exempt from Section 409A if:
  - Award is on service recipient stock
    - Generally common stock of employer or higher parent
  - Exercise price no less than fair market value
    - Guidance available for private companies
  - Award contains no deferral feature
    - Can’t extend income recognition beyond option term
Five Common Situations

1. Bonus Plans (Annual or Long-Term)
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5. Mergers and Acquisitions
4. Employment Agreements

- Now contain lots of 409A boilerplate
- Specific release timing language
- Specific language re bonus payment date
- More conservative definitions of Good Reason/fewer walk-away windows
- Lump sum severance slightly more common
- Post-employment COBRA or retiree medical less common and approached differently
- 409A indemnity?
Five Common Situations

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5. Mergers and Acquisitions
5. Mergers and Acquisitions

- IRS audit activity minimal to date
- Cavity searches occur in corporate transactions
  - Buyer, lender, etc.
  - Valuable to self-audit, categorize and correct or amend documents ahead of transaction rush
  - Typical reps/warranties
5. M&A (cont.)

- Exempt animals are your friends (great flexibility)
  - Short-term deferrals
  - Stock rights (options)
  - Exempt severance

- If substituting stock options, need to comply with 409A rules (e.g., ratio test)

- Is there a “change in control” or “separation from service”

- Special rule allows plan termination upon 409A change in control
409A Corrections—General

- IRS has provided correction guidance for both:
  - Document errors (Notices 2010–6 and 2010–80)

- Many corrections require one-page notice to be attached to both employee’s and company’s next tax return
  - Increase audit risk?
  - Need good communication among internal groups (HR, Tax, etc.)

- Some companies more hesitant than others to use correction guidance
  - Look to argue correction guidance not necessary
  - Even concede violation in some cases
Good News for Immature and Overripe

- Immature = Not yet vested
  - May self-correct while unvested
    - Operational or document problems
    - Can’t use if vests later that year
  - No need to use formal correction guidance or attach notices
  - Can’t abuse it...
    - Only used to correct inadvertent errors
    - No pattern of using rule to abuse 409A
Good News for Immature and Overripe

- Overripe = Closed tax years
  - Proposed income inclusion regs concede that 409A violation in closed tax year is non-event
    - Example: Distribution due in 2007 was never made. Violation occurred in 2007 and can be paid now without 409A problem. Normal income tax applies.
Best Practices

- Educate everyone: No compensatory document goes out without 409A review
- Adopt an overarching “409A Policies and Procedures” document to fill in gaps
- Design for exemption!
  - Short-term deferrals, severance “two-times,” stock rights
  - Simplifies corrections and gives more flexibility to eliminate, amend, accelerate, etc.
  - Watch out for “Retirement” trap!
Best Practices

- Dissect election forms to avoid errors
  - What compensation? (Bonus, annual, plan name)
  - New elections affect existing deferrals?
  - Complying with deferral timing rules?
    - Example: Really “performance based”/“newly eligible”?
  - What if compensation changes during year?

- Public companies keep specified employee list and design for 6-month wait.

- Preemptively compliant stock options
  - For private companies
  - Does it really change behavior?
Questions?

Thank you
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