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Internal Revenue Code § 409A: A Dangerous Trap For Deferred-Compensation Arrangements

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In making decisions about deferred compensation, it is vital for employers to ensure that they do not unwittingly run afoul of the Internal Revenue Code § 409A, as doing so can result in enormous increases to the tax burdens imposed on employers and employees alike. Part of the trick, however, is correctly identifying what constitutes deferred compensation under Code § 409A, and then properly navigating the statute's exceptions.

Section 409A of the Internal Revenue Code ("Code § 409A") requires that all "deferred-compensation" arrangements falling within its scope both fully comply with the statute and be memorialized in writing. Code § 409A, which became effective December 31, 2008, applies to a wide range of compensation arrangements commonly used by employers, from formal structures such as bonus and stock-option plans to measures as simple as individual provisions in employment or severance agreements.

Code § 409A potentially governs any arrangement that provides for deferred compensation, which is defined as an employee's obtaining a contractual right in one year to receive compensation in a subsequent year. The statute imposes specific, detailed requirements regarding the conditions and timing of such deferred-compensation distributions that, if not complied with, can result in draconian tax consequences for both employees and employers.

It should be noted that while this article refers, for the sake of convenience, to "employers" and "employees," Code § 409A also covers deferred-compensation payments made to non-employee service providers (such as board members and independent contractors), so long as those payments fall within the scope of the statute.

The following is a brief summary of Code § 409A, as well as some practical tips to assist employers in complying with the statute. Employers must keep in mind, however, that the provisions of Code § 409A and its accompanying regulations are extremely complex and detailed, and employers are strongly advised to seek the advice of counsel in connection with any specific situation that may fall within the reach of the statute.

Background To Code § 409A

Code § 409A had its genesis in notorious corporate scandals such as the implosion of Enron Corporation in December 2001. During the weeks that preceded Enron's bankruptcy, several of the company's top executives elected to take significant, accelerated distributions of deferred

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compensation that was scheduled to be paid to them later on, taking advantage of so-called "haircut provisions" that permitted such early distributions as long as participants agreed to forfeit a small portion of the compensation. As a result, these executives were able to obtain more than $50 million in accelerated distributions of funds that became unavailable to Enron's creditors following the company's dissolution.

In the wake of such controversies, Code § 409A was enacted as part of the American Jobs Creation Act of 2004. Code § 409A prohibits "haircut provisions" such as those used by the Enron executives, and imposes numerous other requirements intended to ensure that deferred compensation is provided in a predictable and above-board manner.

Scope Of Code § 409A

Code § 409A applies to any compensation plan, agreement or other arrangement that provides for deferred compensation, unless the arrangement falls within one of a number of specified exceptions. Under the statute, a deferral of compensation occurs when an employee "has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable…in a later taxable year." For example, if an employee is notified at the beginning of a particular year that he or she has been awarded a performance bonus that will be paid during the spring of the following year, the bonus is considered deferred compensation for purposes of Code § 409A.

If deferred compensation is subject to a substantial risk of forfeiture – *i.e.*, if, under the terms of the arrangement, there is a significant possibility that the employee will not ultimately receive the compensation – then the compensation falls outside the scope of Code § 409A. The statute and its implementing regulations, however, significantly restrict the circumstances that can constitute "a substantial risk of forfeiture." In particular:

- The inclusion of a covenant in an employment agreement providing that an employee will forfeit certain deferred compensation if the employee competes with the employer after leaving its employ does not render the compensation subject to a "substantial risk of forfeiture." As a result, such compensation is covered by Code § 409A.

- If an employee voluntarily chooses to defer certain compensation rather than receive it currently (*i.e.*, an elective salary deferral), the deferred compensation will not be excluded from the scope of Code § 409A unless it is both subject to a substantial risk of forfeiture *and* materially greater than the compensation the employee would have received if he or she had elected to receive compensation on a current basis.

- If a "substantial risk of forfeiture" is added after the commencement of the service period to which compensation relates, it will be disregarded for purposes of determining whether Code § 409A applies.

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Conversely, the "substantial risk of forfeiture" standard *is* met – and Code § 409A therefore does not apply – where an employee's entitlement to deferred compensation is conditioned on his or her remaining employed through the payout date. Thus, for example, if an employer announces in December of a particular year that bonuses will be paid on April 1 of the following year, but the employer specifies that employees must be employed as of April 1 in order to be eligible for such bonuses, the bonus compensation will not be subject to Code § 409A.

Deferred compensation is also subject to a substantial risk of forfeiture, and thus outside the scope of Code § 409A, where the employer retains unilateral discretion to reduce or cancel the compensation. This exclusion, however, is inapplicable if the relevant facts and circumstances suggest that it is highly unlikely that such discretion will be exercised. (This might be the case where, for instance, an employee to whom deferred compensation may be paid is closely related to, or has effective control over, the person who has formal discretion to reduce or eliminate the compensation.)

Finally, also excluded from the reach of Code § 409A are a number of specific, common forms of employee compensation, including welfare benefits, "short-term" compensation deferrals, payments under qualified retirement plans, and many severance payments. These exclusions are detailed later in this article.

Requirements Of Code § 409A

Under Code § 409A, any deferred-compensation arrangement that is subject to the statute must designate, in writing, at the time of deferral:

- The specific amount that the employee will be entitled to receive (or the formula by which that amount will be determined).
- If the arrangement gives the employee the right to choose when he or she will receive the compensation, the conditions under which such a deferral election may be made. Generally, the election must be made by the end of the taxable year prior to the year in which the employee is to perform the services for which the deferred compensation is to be provided, and the election must be irrevocable.
- The form (*e.g.*, lump sum or installment payments) and timing of the distributions to be made to the employee.

The above provisions need not all be included in the same document for a given deferred-compensation arrangement, though this is often most convenient.

Code § 409A permits distributions of deferred compensation only in the following circumstances:

- At a specified time (or according to a fixed schedule).

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- Upon a participant's death or disability. "Disability" is defined as a period of at least three months in which an employee is unable to engage in any substantial gainful activity or receives disability benefits under an employer-sponsored plan as a result of a medically determinable impairment that is expected to last at least 12 months (or result in death).

- Upon separation from service. Under this criterion, an employee must terminate employment and must not be expected to perform services thereafter (or must do so at no more than 20% of his or her former level).

- Upon a change in ownership or effective control of a company, or a change in ownership of a substantial portion of its assets.

- In the event of an unforeseeable emergency (defined as a severe financial hardship arising from an employee's or dependent's illness or accident, a casualty loss, or other extraordinary events outside an employee's control).

The timing of payments covered by Code § 409A must be objectively determinable – that is, a payment must either be scheduled for a specific date (which can be as broad as a specific calendar year) or be tied to the occurrence of an objectively identifiable event, such as termination of employment or a change in corporate control. A delayed distribution of deferred compensation will be deemed to have been made in a timely fashion so long as it is made within the same calendar year for which it is designated, or, if later, by the 15th day of the third calendar month following the specified distribution date.

Generally, only one time and form of payment may be specified for a given payment event. This rule, however, is subject to two exceptions:

- In the case of a distribution that is triggered by a specific event other than separation from employment, a deferred-compensation arrangement may provide for varying times and/or forms of payment depending on whether the event occurs before or after a specified date.

- With regard to payments that are contingent upon separation from employment, an arrangement may provide for different times and/or forms of payment in the case of a separation that occurs (a) within two years following a change of corporate control or (b) before or after a specified date, a specified age or a combination of the two.

Code § 409A broadly prohibits any acceleration of a designated payment schedule. The one exception to this rule is that an early payment of deferred compensation may be made up to 30 days prior to the specified date.

Where a distribution is triggered by the separation from service of a "specified employee" of a publicly owned corporation, Code § 409A requires that the distribution be delayed by at least six months following the employee's separation. In addition, the employment agreement or other

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document memorializing the compensation arrangement must specifically provide for this waiting period. The definition of a “specified employee” is somewhat complex, but the term generally includes a public company’s most highly paid executives. (As detailed later in this article, however, severance compensation for certain separations from employment is excluded entirely from coverage under the statute, in which event the six-month delay requirement does not apply.)

Finally, Code § 409A restricts employees’ rights to elect to further delay deferred compensation owed to them, which employees sometimes may wish to do with certain forms of compensation such as stock options. If permitted by the applicable compensation arrangement, an employee may elect to delay the distribution of such compensation only if (a) the election is made at least 12 months before the compensation is due to be paid, (b) the election is not effective for at least 12 months after it is made, and (c) the distribution commencement date is delayed for at least five years beyond its previous date (except in cases of death, disability or unforeseeable emergency).

Exclusions From Code § 409A

A number of common forms of deferred compensation are excluded from the reach of Code § 409A:

Qualified retirement plans. Compensation provided pursuant to qualified retirement plans is not subject to the statute.

Welfare benefits. Bona fide employer welfare plans that provide disability pay, death benefits, vacation leave, sick leave or compensatory time off are not included within the scope of Code § 409A.

Certain performance-based compensation. Code § 409A does not apply to deferred compensation that is contingent on the satisfaction, over a performance period of at least 12 consecutive months, of pre-established organizational or individual performance criteria (which may be subjective in nature). The applicable criteria may be set forth in writing at any time up to 90 days following the commencement of the period of service, so long as the outcome is substantially uncertain at the time the criteria are established.

Settlement payments. Payments made in settlement of legal claims by current or former employees (including payment of an employee’s reasonable legal expenses) do not qualify for coverage under Code § 409A. Such payments, however, may not be made simply as a substitute for deferred compensation that an employee would have been entitled to receive in the absence of his or her assertion of such a claim.

Indemnification arrangements. Where an employer agrees to indemnify an employee for potential legal claims arising from his or her performance of services, the arrangement is not subject to Code § 409A.

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Reimbursement of post-termination expenses. Arrangements under which employees are reimbursed for certain post-termination expenses do not fall within the scope of Code § 409A. Included are reimbursements for reasonable outplacement expenses, moving expenses, uninsured medical expenses and expenses that an employee could otherwise deduct as business expenses. These reimbursements are subject to an aggregate monetary limit (for 2010, $16,500), and must be provided within a limited period of time following the employee's separation from service.

Stock-based compensation. Stock options and stock appreciation rights are exempted from Code § 409A provided that, at the time such a right is granted, (a) the number of shares subject to the grant is fixed, and (b) the stock right provides for an exercise price of at least fair market value. In the case of a corporation whose shares are not publicly traded, the fair market value may be determined using any reasonable valuation method that takes into account all material information, including such factors as the corporation's assets, liabilities and cash flow.

Certain independent contractor arrangements. Deferred compensation provided to an independent contractor is not subject to Code § 409A so long as (a) in the year in which he or she obtains a binding right to deferred compensation, the contractor is actively engaged in a business other than as an employee or board member, (b) the contractor provides substantial services to two or more unrelated companies (and no more than 70% of his or her services to any one company), and (c) the deferred compensation is not provided for management services performed by the contractor.

Short-term deferrals. Deferred-compensation arrangements are excluded from Code § 409A to the extent that they provide that (a) payment will be made by the end of a 2½-month period following the end of the employee's or the employer's first taxable year in which the compensation is no longer subject to a substantial risk of forfeiture, and (b) the employee is not allowed to further defer any portion of the compensation. This provision encompasses many standard bonus arrangements, in which employers announce near the end of a calendar year that specific bonus amounts will be paid during the early part of the subsequent year.

In many cases, the applicable 2½-month period will end on March 15 of the year immediately following the year in which a bonus or other deferred-compensation payment is announced (or a substantial risk of forfeiture otherwise ceases to exist), though this period may end later if an employer's fiscal year is not the same as the calendar year. A payment made beyond the 2½-month time limit is nonetheless exempted from coverage under Code § 409A if the delay is caused by an unforeseeable administrative difficulty, or if on-time payment would have jeopardized the employer's ability to remain in business (provided that the payment is made as soon as the factor creating such difficulty has ceased to exist).

Severance payments. Payments made upon separation from employment fall outside the scope of Code § 409A under certain circumstances, including when such payments are provided pursuant to voluntary "window arrangements" or are made in conjunction with involuntary terminations. Some of the most important components of this exclusion from Code § 409A are outlined below:

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Window arrangements. For purposes of Code § 409A, a "window arrangement" is a program instituted by an employer in connection with a reduction in force in order to provide severance benefits to employees who voluntarily resign or are involuntarily terminated from employment. To qualify for exclusion from coverage under Code § 409A, such terminations must take place within a specified period of up to one year, and an employer is not permitted to offer such voluntary arrangements on a routine basis.

Permissible amount and timing of severance payments. Where an employee is terminated involuntarily or voluntarily resigns pursuant to a window arrangement, the severance compensation provided to the employee is excluded from coverage under Code § 409A insofar as it does not exceed the lesser of (a) two times the employee's annual compensation or (b) two times the limit set forth in Code § 401(a)(17) (for 2010, this limit is $245,000). The severance compensation must be paid by the end of the employee's or employer's second taxable year following the separation from employment.

Collective bargaining agreements. Severance compensation that is provided pursuant to a collective bargaining agreement is excluded from coverage under Code § 409A, provided that such compensation is limited to cases of involuntary separation from employment or voluntary resignation pursuant to a "window arrangement."

Definition of separation from employment. For an employee to be considered to have separated from employment for purposes of this exclusion from Code § 409A, there must be no reasonable anticipation that the employee will be employed by the employer (or a member of its controlled group) after the separation date. Further, if, following the termination of his or her employment, an individual provides consulting services that are more than minimal in scope, the individual may be deemed not to have separated from employment, and any severance compensation provided to him or her will be subject to the requirements of Code § 409A.

Termination for "good reason." Many employment agreements provide for employees (often executives) to receive severance compensation in the event that they resign for a specified "good reason." Under a "safe harbor" provision, a resignation by an employee is deemed an involuntary termination for purposes of Code § 409A if the employee resigns pursuant to a good reason provision that includes (and is limited to) the occurrence of one or more of the following events without the employee's consent:

- A material reduction in the employee's base compensation;
- A material reduction in the employee's (or the employee's supervisor's) authority or responsibilities;
- A material reduction in the budget for which the employee is responsible;
- A material change in the geographic location in which the employee works;
- Any other material breach of the provisions of the employee's employment agreement.

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The safe harbor provision also requires that (a) an employee resign within two years following the existence of the good-reason condition, (b) the amount, time and form of severance compensation be substantially the same as with respect to the severance that the employee would have received in the event of an involuntary separation, (c) the employee be obligated to provide notice to the employer of the good-reason condition within 90 days of becoming aware of its existence, and (d) the employer be given an opportunity to "cure" the adverse condition within 30 days after being notified of it.

As an alternative to the requirements of the safe harbor provision, Code § 409A provides for an overall "facts and circumstances" test where an employer seeks to rely on a good-reason provision in an employment agreement. This standard, in general, considers whether conditions equivalent to those of an involuntary termination exist as a result of a materially adverse change in an employee's job situation. If this standard is met (and the compensation limits and timing requirements noted above are satisfied), such severance compensation will likewise be excluded from coverage under Code § 409A.

Employers should be wary of any good-reason provision in an employment agreement or other arrangement that is broader than the safe harbor definition set forth above. Unless such an arrangement is found to satisfy the facts and circumstances test, it may be viewed as potentially entitling an employee to receive severance compensation upon voluntary termination of employment. In such event, the severance compensation will be deemed subject to Code § 409A even if the employee ultimately is separated from employment involuntarily.

Penalties For Non-Compliance With Code § 409A

The consequences of failing to comply with Code § 409A are harsh. The penalties imposed by the statute include immediate inclusion of all deferred compensation in current income, even if the compensation is not yet payable, as well as a 20% penalty and a higher-than-usual rate of interest. All of these sanctions are imposed on the employee to whom the deferred compensation is owed. In addition, the employer is subject to tax-withholding obligations on the compensation.

Code § 409A also renders unattractive the prospect of an employer's agreeing to "gross up" an employee in order to offset such possible penalties. If an employer provides such tax protection to an employee, an additional 20% penalty as well as interest is assessed upon the gross-up payments, and the employer is not permitted to deduct the payments.

Practical Steps For Employers

Given the draconian sanctions imposed for non-compliance with Code § 409A, it is vital that employers take steps to ensure that all of their compensation arrangements either comply with the statute or are excluded from its scope. These steps should include the following:

- Employers that have not done so should examine all of their existing and planned compensation arrangements to determine which of them may raise issues under

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Code § 409A. Again, if an arrangement gives an employee a contractual right in one year to receive compensation in a subsequent year, such compensation may constitute deferred compensation subject to the statute.

- To the extent that any existing compensation arrangements covered by Code § 409A have not been fully reduced to writing, all such arrangements must be so documented. This may necessitate the amendment of some existing documents, as well as the creation of others.

- If a compensation arrangement permits an employee to elect when he or she will received deferred compensation for services to be performed in 2010, the employee must make such a written election by December 31, 2009.

Employers should bear in mind that compensation arrangements can be designed specifically to avoid the strictures of Code § 409A. In particular, so long as compensation is paid to an employee in the same calendar year in which the employee earns it (or within the subsequent 2½-month deferral period), or is conditioned on continued employment or the attainment of specified goals, such compensation falls outside the scope of the statute.

Conclusion

The potential taxability of deferred compensation under Code § 409A is an extremely complex matter requiring the guidance of experienced legal counsel. The Firm is always available to assist employers in determining which of their compensation arrangements may be subject to Code § 409A, and in designing and administering such arrangements in compliance with the statute.

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