

**Code Section 409A
and
Employment Agreements**

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Where did all this come from?

Code Section 409A regulates “deferred compensation” arrangements in response to compensation practices and corporate scandals from the 1990s. It was first released in 2004, received temporary regulations in 2005, various transition guidance until final regulations finally became effective on January 1, 2009. We’re live now, but some guidance on calculating penalties is still pending under proposed regulations.

Enforcement

- The IRS has started its audit program (the Information Data Requests are very detailed).
- Slater v. Commissioner of Internal Revenue, T.C. Summary Opinion 2010-1. Petitioners lose on substantial risk of forfeiture issue.
- Many company auditors are checking compliance.
- Significant issue in mergers and acquisitions.

Scope of Section 409A

- What is a nonqualified deferred compensation plan?
 - Any plan, agreement or arrangement between an employee/service provider and an employer/service recipient that provides for the deferral of compensation.

Scope of Section 409A (continued)

- What constitutes the deferral of compensation?
 - General rule: A deferral of compensation occurs if an employee/service provider has a legally binding right to receive compensation payable in a later year.
 - Example: In Year 1, a participant is promised a bonus equal to a percentage of annual profits to be paid in Year 3, provided the participant remains employed through the payment date. The participant is considered to have a legally binding right to receive the bonus, subject to the condition of continued employment. The arrangement is covered by Section 409A.

Scope of Section 409A (continued)

- Agreements that do not provide for a deferral of compensation:
 - Short-term deferrals
 - Generally, employee must actually or constructively receive the amount by 2½ months after the employee's taxable year in which the amount is no longer subject to a substantial risk of forfeiture

Exceptions to deferred compensation plan status

- Exceptions:
 - Tax-qualified retirement plans
 - Certain welfare arrangements (e.g., vacation leave, sick leave, disability pay, etc.)
 - Others (e.g., certain foreign plans, tax-deferred annuities, simplified employee pensions, etc.)
 - Statutory options (i.e., ISOs or options granted under an employee stock purchase plan) are exempt.
 - **Beware of modifications**

Exceptions (continued)

- Certain equity arrangements:
 - Nonstatutory options and SARs are generally exempt if the exercise price of the option/SAR is not less than the FMV of the underlying stock as of the grant date and there are no deferral features that would delay recognition of income beyond the exercise date.
 - In general, changes to the vesting terms of equity awards will not result in Section 409A concerns.
- Certain severance arrangements.

Consequences of Violating Section 409A

- Violation results in income tax on the full amount deferred for the individual, including earnings, even if there is no payment or liquidity.
- Violation results in an additional tax of 20% on the full amount deferred, including earnings. California gets an additional 20% penalty (totals in the area of 93% tax).
- Interest penalty calculated at the underpayment rate plus 1% from the date the compensation should have been included
- Employers have reporting and withholding requirements

What to look at in an employment agreement for 409A

- Bonus payment terms. Watch for anything payable outside of short term deferrals. If there are amounts payable that could be paid outside of the short term deferrals period, another exemption must be found or the arrangement must be made compliant.
- Severance and change of control terms.
- Release timing issues.
- Definitions, specified employee delay language, and general 409A savings language.

Example

- “You will be paid an annual bonus of up to 50% of your base salary upon achievement of performance goals established by the board.”
 - This is okay provided that the bonus amount, if and when earned, is paid within the short term deferrals period.
 - Better would add: “Any bonus shall be paid no later than March 15 of the year following the year with respect to which such bonus is earned.”

Release Issues

- The IRS has taken the position that benefits conditioned on signing and not revoking a release can result in a deferred compensation arrangement because such terms could allow an employee to shift income from one calendar year to another. Releases are often required for severance pay and change of control benefits.

How to make release terms comply

- Make the plan or agreement comply by specifying a fixed time or schedule subject to the employee signing and not revoking a release:
 - The Company will commence payment of the salary continuation on the first regular payroll date that is sixty (60) days following your termination of employment, provided that prior to such date the release described herein is effective at such time. The first payment thereof will include a catch-up payment covering the amount that would have otherwise been paid during the period between your termination of employment and the first payment date but for the application of this provision, and the balance of the installments will be payable in accordance with their original schedule.

The Boilerplate

- For purposes of this Agreement, a termination of employment will be determined consistent with the rules relating to a “separation from service” as defined in Section 409A of the Code and the regulations thereunder (“**Section 409A**”). Notwithstanding anything else provided herein, to the extent any payments provided under this Agreement in connection with your termination of employment constitute deferred compensation subject to Section 409A, and you are deemed at the time of such termination of employment to be a “specified employee” under Section 409A, then such payment shall not be made or commence until the earlier of (i) the expiration of the 6-month period measured from your separation from service from the Company or (ii) the date of your death following such a separation from service; provided, however, that such deferral shall only be effected to the extent required to avoid adverse tax treatment to you including, without limitation, the additional tax for which you would otherwise be liable under Section 409A(a)(1)(B) in the absence of such a deferral. The first payment thereof will include a catch-up payment covering the amount that would have otherwise been paid during the period between your termination of employment and the first payment date but for the application of this provision, and the balance of the installments (if any) will be payable in accordance with their original schedule. To the extent that any provision of this Agreement is ambiguous as to its compliance with Section 409A, the provision will be read in such a manner so that all payments hereunder comply with Section 409A. To the extent any payment under this Agreement may be classified as a “short-term deferral” within the meaning of Section 409A, such payment shall be deemed a short-term deferral, even if it may also qualify for an exemption from Section 409A under another provision of Section 409A. Payments pursuant to this section are intended to constitute separate payments for purposes of Section 1.409A-2(b)(2) of the Treasury Regulations.

**Severance pay under
Section 409A**

How do we frame the issue?

- Two main questions:
- Is the severance “deferred compensation” under Section 409A?
 - Does it fit the definition of “deferred compensation”?
 - Does an exception apply?
- If it is deferred compensation, does it comply with the rules?
 - If it doesn’t, can the violation be fixed?

What are we talking about when we say “severance”?

- When we refer to “severance” in this presentation we generally mean arrangements in which the right to receive the payments are conditioned on a separation from service (either voluntary or involuntary), found in:
 - Severance plans
 - Severance agreements (& severance provisions in employment agreements)
 - Cash payments
 - Continuation of certain taxable benefits – like continued personal use of company plane, etc.
 - Retention agreements
 - Change in control agreements

Is the Severance “Deferred Compensation”?

A severance payment will fall into the category of “deferred compensation” if:

- The employee is entitled to payment upon a separation from service,
- That is or could be paid out (and included in income) after the tax year in which the employee gains a “legally binding right” to the severance payments (i.e., the payments are no longer subject to a substantial risk of forfeiture), and

None of the exceptions under Section 409A apply to bring the payment outside of the “deferred compensation” category.

Key concept: What is a separation from service?

- An employee separates from service if the employee
 - Dies,
 - Retires,
 - Terminates employment
 - There are specific rules as to what actually constitutes a termination of employment, which can be fairly complex. Agreements including any transition services (e.g., consulting arrangements) should be carefully crafted.

Key concept: When are payments subject to a “substantial risk of forfeiture”?

- A payment generally is subject to a substantial risk of forfeiture (“SRF”) (i.e., is not vested) if it is:
 - Conditioned on future performance (or other substantial restrictions), and
 - The payment is truly at risk.

What are the Exceptions?

- There are 4 exceptions that will remove a severance payment from the realm of deferred compensation:
 1. Short-term deferral exception,
 2. Safe harbor for limited severance payments,
 3. Collectively bargained agreement exception,
 4. Exclusion for certain reimbursements

The Exceptions: Short-term deferral

- Severance is not “deferred compensation” if it is a:
 - Short-term deferral
 - Payments in connection with *an involuntary termination* generally are required to be made (and are made) within 2½ months of the end of employee’s tax year in which the payment right vests.
 - Will still be treated as within the exception if the arrangement requires the payout on a specific date within the short-term deferral time limit, but the payment is not made due to unforeseen administrative or economic impracticability and is made as soon as practicable thereafter.
 - Doesn’t work if the arrangement provides for payment outside 2½ month period, even if the severance is actually paid within it.

The Exceptions: Safe Harbor

- Severance is not “deferred compensation” if it is:
 - Within these safe harbor limits:
 - Under an arrangement that provides for payment upon an *involuntary termination* where:
 - A) The separation pay does not exceed 2x the lesser of:
 - (1) The employee’s annual compensation for the year before the year of termination, or
 - (2) The limits under Code Section 401(a)(17) for that year (\$245,000 for 2010), and
 - B) The amounts are paid no later than December 31 of the 2nd calendar year after the year of termination.

The Exceptions: Collectively Bargained Plans & Reimbursements

- Severance is not “deferred compensation” if it is:
 - Pursuant to an arrangement providing for separation pay upon involuntary termination if under a collective bargaining agreement.
 - A reimbursement for a limited time for a permitted item
 - For example, COBRA payments
 - A “limited period of time” is up to December 31st of the second calendar year following the calendar year in which the separation from service occurred

What if a payment IS Deferred Compensation?

- Just because a severance payment is “deferred compensation” doesn’t mean there is a 409A violation.
- It means that the payment must comply with the deferred compensation rules:
 - “Specified Employee” 6-month rule;
 - Payments must be paid at a specified time, on a specified schedule or upon a permissible event (check definitions);
 - Generally cannot modify to provide an impermissible acceleration or additional deferral.

What is the Specified Employee 6-month rule?

- Deferred compensation payments upon separation of service to “specified employees”:
 - May not be made prior to date 6 months following termination.
 - Agreement can provide that payments due within the six-month period are delayed until the end of the 6-month period (then paid in a lump) or can delay each scheduled payment for 6 months.

Who is a Specified Employee?

- A “Key Employee” as defined in Section 416(i) of the Internal Revenue Code
 - Is an employee of a public company
 - Meets standards related to ownership or compensation
 - Standards based on 401(k) plan rules
- Key employee determination applies for a going-forward period

409A Compliant Agreements: Specified Payment Time/Schedule

- Section 409A allows deferred compensation to be paid out at a specified time or schedule or upon certain enumerated events:
 - Disability (as defined under the regulations)
 - Death
 - Unforeseeable emergency
 - Change in control
 - Separation from service

Specified Payment Time/Schedule

- A fixed schedule or specified date must be set for the payments.
 - Compliant definitions are required.
 - If not properly set in initial agreement in compliance with 409A, then corrections guidance allows corrections under specified circumstances with reporting, and in some cases penalties, depending on the type of failure and timing of the correction.

- Example: On October 1, 2008, Jane enters into an agreement under which she is entitled to receive 3x her base salary of \$200,000 if she is terminated w/o Cause or leaves for Good Reason within 12 months after a CIC. The payments will be made to her in equal monthly payments over 18 months, on the first day of each month. Jane is a Key Employee of a public co. She terminates in 2010. The 6-month delay required, if she is a specified employee. In addition:
 - **“Without Cause” payment:**
 - Subject to an SRF until termination, so not deferred comp until then. At termination:
 - Does not fall within short-term deferral exception (because of 18-month schedule, cannot be paid by March 15 of year following year of termination)
 - Does not fall within “safe harbor” because exceeds 2x the 401(a)(17) limit
 - The payments ARE deferred compensation
 - 6 month Key Employee delay is required and payments on set schedule, so should be OK

Example Continued

- **“Good Reason” payment:**
 - IRS concerned that no SRF after CIC b/c Jane might be in control of termination timing.
 - Short-term deferral and “safe harbor” exceptions probably not available – regardless, exceed ST deferral & safe harbor amount.
 - Payments ARE deferred compensation.
 - Possible that Jane has an impermissible deferral.
 - IRS is quite negative on “Good Reason.”

409A Corrections: IRS Notice 2010-6

- Only available to unintentional failures, all similar failures must be corrected, the company must not be under examination, all correction taxes must be paid, and reporting obligations completed.
- Complicated and fact specific, but available.
- In general, corrections soon after an error is discovered involve lower penalties.

2010-6 Noteworthy Issues

- Plans with “as soon as practicable” for the payment timing are not automatic failures under 409A. The payment event is treated as the payment date, so payments must be made by the end of the later of (i) the end of the year of the event or (ii) the 15th day of the third month following the event.

2010-6 Noteworthy Issues Continued

- Ambiguous payment terms like “termination of employment” or company “acquisition” do not result in a document failure and are generally eligible for correction.
- Savings clauses are recognized for interpretation of ambiguous terms.
- Releases which could allow the employee to select the year of payment are a failure unless corrected.

Settlement Tax Issues

- Settlement and judgment tax efficiency takes planning, so consider these issues early.
- For plaintiffs, the difference between capital gains and ordinary income is as great as 20% (15% for capital gains against a top marginal rate of 35%).
- Corporations can recover damages to a capital asset tax free up to the basis of the capital asset, while a recovery for lost profits is fully includable in income.

Origin of the Claim Test

- The tax result of a settlement or judgment is determined by reference to the underlying claim being addressed.
 - A payment to compensate for lost profits is taxable, while a payment to compensate for loss of goodwill is a capital impairment that may be tax free.
 - Most has been developed from cases.

Tax Analysis

- Code Section 61(a) provides that income includes “all income from whatever source,” so the baseline is that all income is taxable unless an exclusion applies.
- The IRS position is that income is defined as broadly as possible, while exclusions are narrowly construed.

Exceptions to Income Inclusion

- The most important is for recoveries for personal physical injuries and physical sickness under Code Section 104.
 - The scope of this exception can reach beyond personal physical injuries to include reimbursement for lost wages and reimbursement for medical expenses.

Back Pay

- A recovery for back pay is treated in the same manner as salary or wage payments: ordinary income, and generally as wages for the purposes of federal income, FICA, and FUTA tax withholding.

Lost Profits and Harm to Capital Assets

- A plaintiff's recovery for lost profits will generally be taxed as ordinary income. So a claim against an insecticide producer for crop damage will result in ordinary income because the crop damage resulted in lost profits.
- Where the recovery compensates a plaintiff for damage to a capital asset, the recovery constitutes a tax-free return of capital to the extent of the taxpayer's basis in the asset.

Punitive Damages

- The general rule for punitive or exemplary damages is that they are taxable income. This now is settled with respect to punitive damages arising out of personal injury.

Planning and Substantiating Tax Treatment

- The IRS will scrutinize any agreed upon tax treatment because the interests of the parties are often no longer adverse.
- The IRS will give most weight to the terms of the complaint which frames the nature of the case and sets forth the plaintiff's initial demands.
- The IRS will also examine the intent of the payor.
- Building a documentary trail that is consistent with the intended tax treatment will reduce the risk of the IRS challenging recoveries (specificity in settlement agreement and a reasonable relationship between the settlement agreement and what a jury might have awarded).

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