Section 409A and Deferred Compensation
Internal Revenue Code
Section 409A Overview
What Is Section 409A

♦ Enacted in October 2004.

♦ Designed to create strict rules to govern deferred compensation.

♦ Enactment resulted from Enron, Delta and lenient judicial rulings under constructive receipt principle.
Effective Dates of Section 409A

◊ Generally effective January 1, 2005.
  ▪ Must comply with reasonable interpretation of statute and Q&A Notice issued by IRS in December 2005.

◊ Final regulations became effective January 1, 2009.
  ▪ All documents had to be in written compliance by that date.
  ▪ Could follow these regulations before that date in operation.
Section 409A – Analysis Flow Chart

Is the individual a **Covered Employee**?
- Yes → Does the plan provide **Deferred Compensation**?
- No → **409A Not Applicable**

**409A Penalties Apply**
- Individual subject to immediate taxation and tax penalties
- Company must report deferred compensation on Form W-2 or 1099

**409A Not Applicable**
- Is there an applicable correction?
- Yes → Company must report deferred compensation on Form W-2 or 1099
- No → Is the plan in **Compliance** in form and operation with all 409A requirements?
- Yes → No 409A Penalties Apply
- No → **409A Not Applicable**
Code Section 409A – Why You Should Care

- 409A applies to a broad array of compensation arrangements, some of which are not intuitive.
- Compliance requires detailed attention to written documentation and administration.
- Severe penalties imposed on “service providers” (employees/directors/covered independent contractors) for failures.
Penalties for Violating Section 409A

- If a covered arrangement fails to comply with 409A either in form (documentary requirements) or in operation (operational requirements):
  - All amounts deferred under the arrangement become subject to immediate taxation;
  - 20% penalty tax applies to all amounts deferred; and
  - Additional interest penalty.

- Penalties also apply to other plans of the “same type.”
Penalties for Violating Section 409A

“Plan” is defined very broadly, and includes all other plans that are “similar plans” subject to 409A that fall into the same category.

The separate categories are:

- Individual deferrals under account balance plans;
- Company contributions (including match) under account balance plans;
- Non-account balance plans;
- Separation pay plans for involuntary or window program terminations;
- Split-dollar life insurance programs;
- Right to in-kind benefits or expense reimbursements (as long as not a substantial portion of compensation);
- Deferrals of foreign earned income;
- Stock rights; and
- All other deferrals of compensation.
Who Is Covered by Section 409A

- All individuals who are US taxpayers.
- Certain independent contractors are excluded.
- Nonresident aliens with no US source income (or US source income less than the Section 402(g) limit ($17,500 in 2013) are excluded.
- Transition rules apply for nonresident aliens who begin working in the US.
What is Section 409A Deferred Compensation

♦ Unless an exemption applies, all plans or arrangements that provide for the deferral of compensation are subject to, and must comply with, 409A.

♦ A “deferral of compensation” generally occurs when:
  - A legally binding right to compensation arises in one taxable year; and
  - The compensation could be payable by a service recipient to a service provider in a subsequent taxable year.
Examples of Covered Arrangements

- Nonqualified plan (voluntary deferral (DC) plans, SERPs, etc.);
- Individual deferral arrangements;
- Employment agreements/offer letters;
- Bonus programs;
- Long-term cash or equity compensation plans;
- Stock appreciation rights and stock options unless exempt (see below);
Examples of Covered Arrangements

- Change in control agreements;
- Severance plans and agreements;
- Split-dollar life insurance;
- Retention arrangements;
- Consulting agreements;
- Perks/reimbursement arrangements;
- Gross-ups; and
- Indemnification agreements.
Exemptions – Excluded Arrangements

The following arrangements are not subject to 409A:

- Qualified plans (such as 401(k) plans, ISOs and ESPPs).
- Bona fide vacation, sick leave, compensatory time, disability or death benefit plans.
- Nonqualified stock options and stock appreciation rights (i) issued for employee stock, (ii) at FMV and (iii) with no other deferral rights.
- Restricted stock.
  - Dividends on restricted stock may be subject to 409A.
  - Many restricted stock unit (RSU) arrangements are subject to 409A.
Exemptions –
Excluded Arrangements

- “Short-Term Deferral” Exemption – amounts that are paid within 2½ months of the end of the tax year in which they become vested.
- “Involuntary Separation Pay” Exemption – payments solely upon involuntary termination may be exempt.
- Certain foreign retirement plans.
Compliance with Section 409A

♦ Deferral Election Rules:

- Election to defer compensation generally must be made (irrevocably) before the beginning of the tax year in which the compensation is earned (i.e., before any of the services relating to that compensation is performed).
Compliance with Section 409A – Requirements

- Distribution Rules:
  - Only certain distribution “triggers” are permitted:
    - Separation from service;
    - Disability;
    - Death;
    - Specified time or fixed schedule;
    - Change in control; and
    - Unforeseeable emergency.
  - Each “trigger” has a specific definition and specific rules.
Compliance with Section 409A – Requirements

Distribution Rules (continued):

- Form and timing must be determined when the compensation is deferred, and changes in payment timing are severely restricted.
  - Any change in form or timing must be made at least 12 months in advance of scheduled payment and must defer the scheduled payment by at least 5 years.
  - Payment of deferred compensation cannot be accelerated, subject to a few exceptions. For example:
    - Unforeseeable financial emergency;
    - Up to 402(g) limit ($17,500 for 2013); and
    - Certain terminations.
Compliance with Section 409A – Requirements

♦ Distribution Rules (continued):
  ■ Six-month delay for certain distributions to key employees.
    ➢ Applies only to employees of publicly-traded companies.
IRS Voluntary Correction Programs for Section 409A Failures

- The IRS has adopted programs for correcting certain 409A operational errors and for correcting certain 409A document failures.
- These programs provide limited opportunities to correct certain failures, with no or reduced penalties.
- Corrections generally entail disclosure to the IRS (on either or both the employer’s and the employees’ tax returns).
Key Concepts for Section 409A
Separation from Service

- Separation from service generally is a termination of employment, but is different from a termination in certain respects:
  - A separation from service occurs on the date the employer and employee reasonably anticipate either:
    - That no further services will be performed, or
    - That the level of the employee’s bona fide services will permanently decrease to no more than 20% of the average of the bona fide services performed over the preceding 36 months.
Separation from Service

♦ Generally, whether a reduction in services is expected to be permanent is based on the facts of a particular case.

♦ If an employee terminates but continues to provide services as an independent contractor, those services are counted in determining whether the threshold for separation from service is met.
Separation from Service

- A plan may provide for separation upon a permanent decrease in services to a level greater than 20%, but the threshold must be less than 50%.

- Services for all members of the employer’s controlled group are counted, using 50% common ownership.
  - Up to 80% ownership may be used instead of 50%, or less than 50% if based on a legitimate business purpose.
Separation from Service – Leaves

♦ A separation from service will not occur during the first 6 months of a bona fide leave of absence from which the employee is expected to return, or during 29 months of leave if due to disability.

♦ A separation from service will not occur during any period of a bona fide leave of absence if the employee has a right to reemployment under contract or by law.

♦ “Terminal” or “bridging” leaves of absence are specifically disapproved.
Change in Control

- 409A regulations only provide for change in control of a corporation.
- Employer can choose among the various options.
- Only applies to payment timing, not vesting rules.
- Any requirement to certify or approve that a change in control has occurred must be purely ministerial and not discretionary.
Change in Control

♦ Person or group acquires:
  - More than 50% of total FMV or voting power;
  - 30% or more of voting stock within 12 months; and
  - 40% or more of the FMV of corporation’s total gross assets within 12 months.

♦ Majority of directors replaced within 12 months by unendorsed candidates (but this event does not apply to subsidiaries).

♦ Can use higher percentages if done by deadline for establishing time of payment.
Change in Control – Relevant Corporation

- Corporation for whom employee is performing services at the time of the change.

- Corporation(s) liable for payment – but only if deferred compensation is attributable to past services for that corporation or there is a bona fide business purpose for such corporation to be liable for payment.

- Direct or indirect parent of one of the above in a chain of at least 50% ownership.
Plan Aggregation

- Each employee is considered to have a separate plan.
- All of the employee’s plans of each specified type are considered a single plan.
- If there is an error in one plan type, it taints all of that type of plan for the relevant employee(s).
Plan Aggregation - Types

- Elective deferrals by participants under account balance plans;
- Employer contributions under account balance plans;
- Defined benefit type plans;
- Separation pay arrangements;
- In-kind benefits and reimbursements;
- Split-dollar life insurance;
- Foreign plans; and
- Stock options and stock appreciation rights.
6-Month Delay

♦ Provides that amounts may not be paid within 6 months after the date of separation;

♦ Applies only to “specified employees”;

♦ Applies only to payments triggered by separation from service that are subject to 409A;

♦ Applies only to publicly traded companies and their affiliates; and

♦ Must be stated in written document.
Specified Employees

- Top 50 highest paid officers making over a specified dollar amount (currently $165,000).
- 5% owners.
- 1% owners with annual compensation over $150,000.
- By default, the determination is made using compensation and status during the calendar year, and “specified employee” status becomes effective as of the following April 1:
  - The delay between the determination period and effective date gives the employer time to do the calculations; and
  - These defaults can be changed in the plan.
Acceleration

- The general rule is that amounts subject to 409A may never be paid early, only delayed.
- There are some exceptions that would allow the benefit to be paid early, but even in those cases the employee is not permitted to elect early payment (employer decides).
Exceptions to Anti-Acceleration

- Termination of the plan, subject to certain restrictions;
- Domestic relations orders;
- Payment of FICA taxes and related income taxes;
- Limited cashouts (up to $17,500);
- Unforeseeable emergency or hardship distribution;
- Payment of state, local and foreign income taxes;
- Cancellation of deferral elections due to disability; and
- Limited offsets for amounts the employee owes to the employer (up to $5,000).
Substantial Risk of Forfeiture

Entitlement to benefit is either:

- Conditioned on the performance of substantial future services; or
- Conditioned on the occurrence of a condition related to the purpose of the compensation

AND

The possibility of forfeiture is substantial.
Substantial Risk of Forfeiture

- Involuntary termination without cause is considered a substantial forfeiture condition.
- Voluntary termination for “good reason” may be a substantial forfeiture condition if good reason definition is sufficient.
- Noncompete violations do not constitute a substantial risk of forfeiture for 409A.
- Forfeiture conditions may not be added or extended after the compensation is granted without providing some additional benefit.
Traditional Deferred Compensation Plans
Overview

♦ How does money go into the plan?
♦ When can it be paid out?
♦ How can it be paid out?
♦ How can scheduled payments be changed?
How Does Money Go Into the Plan?
How Does Money Go Into the Plan?

- General rule.
- Four exceptions:
  - Initial eligibility;
  - Performance-based compensation;
  - Forfeitable amounts; and
  - Commissions.
General Rule

- Generally, deferral elections must be made before the year in which amounts are earned.
- Trailing pay in the first paycheck of the year will need to be treated as if it was earned in the prior year, unless it is paid for a payroll period that includes December 31.
Exception #1
Initial Eligibility

- New participants can make deferral elections within their first 30 days of eligibility.
  - A new participant is one who has first become eligible for a plan or any aggregated plan.
  - An individual who previously participated in the plan or any aggregated plan is not considered a new participant for this purpose, unless:
    - He has received a distribution of his entire benefit under the plan; or
    - He has not been eligible to make or receive contributions under the plan for at least 24 months.
Exception #2
Performance-Based Compensation

- Performance-based compensation relating to a performance period of at least 1 year (e.g., annual bonuses or long-term incentive plans) may be deferred before the last 6 months of the performance period.
Exception #2
Performance-Based Compensation

♦ Special rules apply to determine what constitutes “performance-based” compensation:
  - The performance period must be at least 12 months long;
  - The performance criteria must be established within 90 days after the start of the performance period;
  - The individual must be employed continuously from the date the performance criteria are established until the date he makes his deferral election; and
  - The performance criteria is not substantially certain to be satisfied at the time of either grant or deferral election.
Exception #3
Forfeitable Amounts

- If an individual is granted compensation that is subject to vesting, he may elect to defer within 30 days after the date of grant as long as the compensation remains forfeitable for at least 12 months after the deferral election (i.e., 13 months from date of grant).

  - This will apply even if an earlier vesting date will occur due to death, disability or change in control within the 13-month period, but the deferral election will not apply if vesting is actually triggered by one of these events.
Exception #4

Commissions

♦ Commission compensation is treated as earned in either:
  - The year in which the customer pays for the service or product; or
  - The year in which the sale occurs, if this rule is applied consistently to all similarly situated employees.

♦ “Commission compensation” means compensation:
  - Earned primarily for direct sales;
  - Substantially all of which is related to sales price or volume; and
  - Contingent on receipt of price from customer or closing of the transaction.
What Else Needs to be Included in the Deferral Election?

♦ At the time a participant elects to defer compensation under a plan, the participant also must elect:
  
  ■ When that deferred compensation will be paid to the participant (*i.e.*, the payment trigger); and
  
  ■ In what form it will be paid (*e.g.*, lump sum or installments).
When Can Deferred Amounts Be Paid Out?
Six Permissible Payment Events

- Separation from Service;
- Disability;
- Death;
- Fixed Time or Schedule;
- Change in Control; and
- Unforeseeable Emergency.
Fixed Time or Schedule

- The timing can be based on specified dates, ages, or other events that are nondiscretionary and objectively determinable as of the date the amount is deferred, and may be while an individual is still employed.
Unforeseeable Emergency

- Hardship withdrawals are permitted due to unforeseeable emergency.
  - More stringent standard than 401(k) plan hardship withdrawals.
  - May also allow participant to revoke deferral election.

- Any other unscheduled in-service withdrawals, including withdrawals with forfeiture (i.e. “haircut withdrawals”), are prohibited under Section 409A.
How Can Deferred Compensation Be Paid Out?
Payment Timing

♦ If payment is due on a specific date, payment will be deemed timely if paid by the end of the calendar year in which the payment date occurs (or 15th day of third month following the payment date, if later).

♦ A plan may provide for payment during a specified period instead of on a particular date.

- May be a specified taxable year.
- May be any period that begins and ends in the same taxable year.
- May be a period of up to 90 days even if the period overlaps taxable years, as long as the employee cannot choose the taxable year of payment.
Alternative Payment Dates

♦ Generally, one alternative set of payment dates is permitted with respect to each permissible payment event.

♦ A plan may provide for a different form of distribution for each of the following types of separation from service:
  - Separations within 2 years following a change in control.
  - Separations occurring after a designated date (e.g., attaining a particular age) and/or completing a designated amount of service.
  - Separations occurring before that date.
How Can Scheduled Payments Be Changed?
Limited Option To Delay Payment Date

- Scheduled payments generally cannot be accelerated.
- To delay a payment date:
  - The election to delay must be made at least 1 year before the originally scheduled payment date; and
  - The newly selected payment date must be at least 5 years after the payment date.
Changes To Form of Payment

- Changing between a lump sum and installments distribution is permitted as long as the election satisfies the 1-year/5-year election rule keyed off of the commencement date for the originally scheduled payments.

- The ability to change the timing or form of each payment in a series of installments is determined by whether the installments are treated under the plan as a single or separate payments.
  - Default is a single payment.
Supplemental Pension Plans
Basic Plan Types

- SERPs.
- Section 415 Excess Plans.
- Defined benefit formulas.
  - Section 409A “non-account balance” plans.
- Defined contribution formulas.
  - Section 409A “account balance” plans.
Some Common Features

♦ Make up or restore benefit amounts under tax-qualified retirement plans that are limited by IRC qualification requirements.

♦ Benefits generally accrue over participant’s period of service.
  ■ Benefit amounts based on combination of participant’s years of service and average pay (DB SERPs).
  ■ Benefits based on amounts credited annually to participant accounts (DC SERPs).

♦ Nonelective, employer-provided benefits.
Special Section 409A Considerations

- Deadlines for specifying time and form of payment(s).
- Elections among alternative annuity forms.
- Linked plans.
- FICA rules.
- Grandfathered amounts.
The time and form of payment of SERP benefits generally must be established in advance.

- Participant elections among alternative payment timing or forms (e.g., installments, annuities, lump sum distribution) generally must be made before benefits are earned.

- Special rule for certain excess plans: 409A permits such elections within 30 days after the end of the year the participant first accrues a benefit.

- Applies to plans that provide benefits solely in excess of IRC qualified plan limits.
Changes to Time and Form of Payments - Annuities

- Changes to the time and form of payment generally must comply with 409A’s subsequent election rules.

- *Special rule for annuities*: employee may change payment election of amounts payable in the form of an annuity to another actuarially equivalent annuity form, at any time before the first annuity payment.
  - Subsidized J&S annuities are generally treated as actuarially equivalent to life annuities.
  - Certain features may be disregarded in determining whether amounts may be treated as annuity (e.g., term certain and pop-up features, COLAs, etc.).
    - Those features must, however, be considered in determining actuarial equivalence.
Issues with Certain Linked Plans

♦ SERP formulas often provide an offset for benefits payable under a qualified retirement plan or another nonqualified plan.

♦ Shifting a benefit between the SERP and the other plan may result in an impermissible change in payment timing (acceleration or delay) of the SERP benefit in violation of 409A.

  E.g., if time or form of payment is different under the two plans.

♦ Regulations provide some relief from potential 409A violations for nonqualified plans linked to a tax-qualified employer plan.
Plans Linked with a Tax-Qualified Plan

- If an amount payable under a nonqualified plan is linked to a tax-qualified plan, certain actions under the qualified plan that affect the amount of the SERP benefit will not result in an impermissible change in payment timing, including:
  - Changes in qualified plan limits;
  - Participant election to receive a subsidy or an ancillary benefit under the qualified plan;
  - Certain qualified plan amendments, such as to add or remove a subsidy or ancillary benefit, or to increase or limit accruals; and
  - Certain actions or inactions with regard to making contributions to a qualified plan.

- This relief also applies to certain broad-based foreign retirement plans.
FICA Considerations

♦ For many SERPs (non-account balance plans), benefits are required to be taken into account as FICA wages when benefits are “reasonably ascertainable.”
  - Generally, means when the amount and time and form of payment is known.

♦ Under this rule, FICA tax may be due before it can be withheld from a benefit payment.

♦ 409A provides some flexibility by permitting acceleration of a portion of the 409A benefit in order to pay the participant’s share of FICA tax (and related income taxes).
  - This rule is not required to be in the plan document for the employer to use it.
Grandfathering Issues

- Application of 409A’s grandfathering rules can be particularly complicated in regard to DB SERPs linked to qualified plans.

- Determining value of the grandfathered benefit (amount earned and vested on December 31, 2004) often involves multiple calculations.
  - DB SERP accrual amount and qualified plan offset amount, based on plan actuarial assumptions.
  - May involve later adjustments (increases) for actuarial subsidies (such as favorable early retirement factors).

- High potential for 409A operational failures.
Employment Agreements
Potential Application of Section 409A to Employment Agreements

- Severance Pay
- Benefits Continuation
- Reimbursements
- Tax Gross-Ups
If Severance Benefits are Subject to Section 409A

- 6-month delay may apply (if public company).
- Agreement must specify Section 409A-compliant payment date or schedule.
- Limited flexibility to alter payment timing.
- Conditioning payments on execution of release may be problematic.
- Tax penalties for noncompliance.
Potential Section 409A Exemptions

- “Short-Term Deferral” Exemption.
- Separation Pay Exemption.
- In-kind benefits and reimbursements for limited period after separation.
Short-Term Deferral Exemption

♦ Amounts paid within 2½ months after the year in which the payment is no longer subject to a risk of forfeiture.

♦ Lump-sum severance and some installments may qualify if payable only upon:
  - Involuntary termination.
  - Voluntary termination with “good reason” (if good reason properly limited).

♦ No limit on amount.
Short-Term Deferral Exemption

If installments continue beyond the 2½–month period, payments within the period may still be exempt if agreement designates each installment as a separate payment.

*Example:* Lump-sum severance payable within 60 days of involuntary termination – entire payment is exempt.

*Example:* Monthly severance payments for 12 months.

- If agreement has “separate payment” language, payments that fall within the short-term deferral period will be exempt.
- Other payments may qualify for Separation Pay Exemption discussed below.
- Non-exempt payments must comply with Section 409A.
Short-Term Deferral Timing Issues

♦ **Unpredictability:** If payments continue for more than 2½ months after termination, exempt amount will depend on date of separation from service.

  - *Example #1:* Terminate on December 31, payments due in first 2½ months are exempt.
  - *Example #2:* If terminate on January 1, payments due in first 14½ months are exempt.

♦ **Separate Payment Requirement:** If any amounts could be paid after 2½ months following the end of they year, agreement must designate each payment as a separate payment or no amounts are covered by the exemption.  
  - Separation Pay Exemption discussed below could still apply.
Separation Pay Exemption

- **Separation Pay Exemption:** Applies only if payments are on account of involuntary termination.

- **Dollar Limit:** 2 times pay or (if less) 2 times the qualified plan compensation limit ($255,000 for 2013, or $510,000).

- **Timing Requirement:** Paid by end of second calendar year following separation (e.g., by December 31, 2015 for separation on July 1, 2013).

- **Separation from Service:** Must use 409A definition.
Involuntary Termination

♦ Both the Short-Term Deferral Exemption and the Separation Pay Exemption are limited to severance payable only upon involuntary termination.

♦ “Good Reason” termination may qualify as involuntary termination.
  - Material negative change in employment relationship.
  - Tantamount to constructive termination by employer.

♦ Severance cannot be payable under any other circumstances.
Good Reason Definitions in Employment Agreements

♦ Safe Harbor:
  ■ Material diminution in base compensation.
  ■ Material diminution in authority, duties or responsibilities (of employee or supervisor).
  ■ Material diminution in budget authority.
  ■ Material change in work location.
  ■ Material breach of terms of employment agreement.
  ■ Employee must give notice and employer must have right to correct.

♦ Other definitions may also qualify under constructive termination standard.
“Stacking” of Section 409A Exemptions

Agreement may be structured to combine Short-Term Deferral Exemption and Severance Pay Exemption.
“Stacking” of Section 409A Exemptions

**Example:** Executive is entitled to 1 year’s pay ($1 million) upon involuntary termination.

- **Alternative #1:** Pay entire $1 million in a lump-sum 60 days after termination (Short-term Deferral).

- **Alternative #2:** Pay $500,000 in a lump-sum 60 days after termination (Short-Term Deferral) and $500,000 in equal monthly payments over 2 years (Separation Pay Exemption).

- **Alternative #3:** Pay $1 million in equal monthly installments over 3 years.
  - Payments due by 2½ months after year of termination will be covered by the Short-Term Deferred Exemption (if designated as separate payments).
  - Payments due by end of second calendar year after termination (up to $510,000) are covered by Separation Pay Exemption.
  - Remaining payments are subject to 409A.
Employment Agreement

Release Issues

- IRS takes position that standard release timing provision (e.g., payment within 90 days of termination) subject to employee signing and not revoking a release violates 409A.

- Even though payment period satisfies 409A, employee may be able to choose the year of payment by deciding when to sign and deliver the release.

- Even for exempt severance, release timing may result in constructive receipt.
Employment Agreement
Release Issues

♦ Permissible Release Provisions:
  - Payment on 90th day following separation.
  - Payment within 90 days of separation, but if 90-day period spans two calendar years, payment will always be made in the second year.
Exempt In-Kind Severance Benefits and Reimbursements

♦ Exemption applies to payments on separation from service (including a voluntary separation).

♦ Covered expenses:
  ■ Medical benefits for COBRA period;
  ■ Deductible business expenses;
  ■ Outplacement; and
  ■ Moving expenses, including reimbursement for loss on sale of residence.

♦ Limited period of time – Expenses must be incurred by last day of the second year following year of separation.

♦ 6-month delay does not apply.
Non-Exempt Benefit/Reimbursement Requirements

♦ Objective definition of benefits/expenses.

♦ Prescribed reimbursement period.
  ■ May be for life.

♦ Only single-year limits.
  ■ Reimbursements in one year cannot affect amounts available in another year.
  ■ Exception: lifetime maximum for medical benefits.

♦ Reimbursement timing – by end of following calendar year.

♦ No exchange or liquidation.
  ■ For other benefits or cash.

♦ 6-month delay applies.
Tax Gross-Ups

- 409A generally requires that reimbursement be made by end of year following year in which employee remits the taxes.
- Covers federal, state and local taxes.
- Audit or Litigation Expenses – by end of year following the year in which audit is complete or litigation is resolved.
Legal Fee Reimbursements

- General reimbursement timing okay.
  - Reimburse by end of year following year in which fees are incurred.

- Reimbursements conditioned on employee prevailing in litigation may be problematic.
  - Litigation may not be resolved by deadline for timely payment.
  - Not clear that Short-Term Deferral Exemption applies.
  - One solution is to pay under regular timing rule but provide for clawback if employee loses.
Common Drafting Errors

♦ Failure to include “separate payment” language to maximize Short-Term Deferral Exemption.

♦ “Good Reason” definition triggers lack materiality.

♦ Notice requirement – payment timing keyed to expiration of required notice period rather than actual separation from service date.

  Solution – increase amount of severance if separation from service precedes end of notice period.

♦ Faulty release timing.
What are the Consequences of Violating Section 409A?

- **Immediate Income Inclusion**
  - Additional taxable income for both federal and state taxes.

- **Additional 20% Federal Tax**
  - Some states (California) have mirror 409A penalties.

- **Federal Premium Interest Tax**
  - Based on hypothetical underpayment penalty that would have applied had amount been included in income in year when it was first deferred (or, if later, first vested).
IRS Enforcement of Section 409A

♦ IRS using Information Document Request forms during audits of employers to gather information and audit arrangements subject to 409A.

♦ In a recent court case, IRS won imposition of 409A penalties related to stock options.
  - Over $4,000,000 in additional 409A taxes and penalties.
What Amount is Subject to Section 409A Penalties?

♦ **Total Vested Benefit.** Amount is year-end vested benefit plus any distributions made during the year.

- **Grandfathered Benefit.** Amounts grandfathered under 409A are not included unless 409A violation voids grandfathered status.

- **Operational Error.** Amounts under all aggregated plans and arrangements are subject to 409A penalties.

- **Document Error.** Only amount under plan with document error is subject to 409A penalties.
Example of Section 409A Violation – Incorrect Amount Deferred

- Elective Deferral Account Balance Plan.
- Starting in 2005, election to defer $100,000 on last day of each year.
- 5% annual earnings.
- In 2013, $200,000 erroneously deferred.

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</tr>
<tr>
<td>2013</td>
<td>$200,000</td>
<td>$47,746</td>
<td>$1,202,656</td>
</tr>
</tbody>
</table>
### Example of Section 409A Violation – Premium Interest Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Deferred</th>
<th>Federal Income Tax Rate</th>
<th>Increase in Federal Income Tax</th>
<th>Income Tax Due Date</th>
<th>Premium Interest Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$100,000</td>
<td>35%</td>
<td>$35,000</td>
<td>4/15/2006</td>
<td>$15,789</td>
</tr>
<tr>
<td>2006</td>
<td>$105,000</td>
<td>35%</td>
<td>$36,750</td>
<td>4/15/2007</td>
<td>$12,581</td>
</tr>
<tr>
<td>2007</td>
<td>$110,250</td>
<td>35%</td>
<td>$38,588</td>
<td>4/15/2008</td>
<td>$9,379</td>
</tr>
<tr>
<td>2008</td>
<td>$115,763</td>
<td>35%</td>
<td>$40,517</td>
<td>4/15/2009</td>
<td>$7,197</td>
</tr>
<tr>
<td>2009</td>
<td>$121,551</td>
<td>35%</td>
<td>$42,543</td>
<td>4/15/2010</td>
<td>$5,592</td>
</tr>
<tr>
<td>2010</td>
<td>$127,628</td>
<td>35%</td>
<td>$44,670</td>
<td>4/15/2011</td>
<td>$4,010</td>
</tr>
<tr>
<td>2011</td>
<td>$134,010</td>
<td>35%</td>
<td>$46,903</td>
<td>4/15/2012</td>
<td>$2,469</td>
</tr>
<tr>
<td>2012</td>
<td>$140,710</td>
<td>35%</td>
<td>$49,249</td>
<td>4/15/2013</td>
<td>$1,064</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$58,081</strong></td>
</tr>
</tbody>
</table>
Example of Section 409A Violation

<table>
<thead>
<tr>
<th>Incorrect Amount Deferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013 Account Balance is</td>
</tr>
<tr>
<td>$1,202,656</td>
</tr>
<tr>
<td>Immediate Income Inclusion:</td>
</tr>
<tr>
<td>Federal Income Tax at 39.6%</td>
</tr>
<tr>
<td>$476,252</td>
</tr>
<tr>
<td>Georgia Income Tax at 6%</td>
</tr>
<tr>
<td>$72,159</td>
</tr>
<tr>
<td>Additional 20% Tax</td>
</tr>
<tr>
<td>$240,531</td>
</tr>
<tr>
<td>Premium Interest Tax</td>
</tr>
<tr>
<td>$58,081</td>
</tr>
<tr>
<td><strong>Total 409A penalty taxes</strong></td>
</tr>
<tr>
<td><strong>$298,612.68</strong></td>
</tr>
<tr>
<td>Total 2013 Taxes</td>
</tr>
<tr>
<td><strong>$847,024</strong></td>
</tr>
</tbody>
</table>
Overview of Section 409A Correction Programs

- IRS has 2 programs permitting limited correction of specified operational and document failures to comply with 409A.

- Differences from Qualified Plan Corrections.
  - Generally must report violation to IRS, *(i.e., no self-correction).*
  - No ability to craft own correction.
  - No IRS filing fee.
  - Some 409A penalties may still apply.
Correction of Section 409A Operational Errors: General Rules

♦ 2 Year Window from year of error to make correction under IRS program.

♦ No Correction During IRS Audit of employee’s individual tax return for year of failure.

♦ No Intentional Failures.

♦ Repeated Error Generally Not Eligible for Correction.
Operational Error – Excess Deferral

♦ Scenario:
  - Non-insider employee has election to defer $10,000 from 2012 bonus.
  - Employer mistakenly defers $20,000.
  - Employer discovers error in 2013.

♦ Correction Steps taken before end of 2013:
  - Employer pays $10,000 excess to employee.
  - Employer may not compensate employee for late payment.
  - Employer must forfeit earnings on $10,000.

♦ Note: if correction not made until 2014 (i.e., second year after failure), employee owes 409A additional 20% tax.
Operational Error – Early Payment

♦ Scenario:
  - Non-insider employee is scheduled to be paid $50,000 in 2015.
  - Employer mistakenly pays $50,000 in 2012 when employee terminates employment.

♦ Correction Steps taken before end of 2013:
  - Employee repays company $50,000 with after-tax dollars.
  - Employee does not redo 2012 income tax, but is allowed a deduction for repayment in 2013.
  - Employee will receive and be taxed on payment in 2015.
  - Employee pays company interest on repayments.
  - Employer discretion to adjust for earnings or losses.
Correction of Section 409A Operational Errors – Employer Reporting

- Company must attach statement regarding correction to its federal income tax return that includes:
  - Identity of affected parties.
  - Description of failure including date and amount involved.
Correction of Section 409A Operational Errors – Employee Reporting

- Company must provide each employee affected by failure not corrected in same year similar statement regarding correction.

- Employee must file this statement with his individual tax return, if failure is not corrected in same year.
Correction of Section 409A
Document Errors – General Rules

♦ **Employer Must Identify and Correct All Plans** that have a substantially similar document failure.

♦ **No Correction During IRS Audit** of employer or employee’s tax return for year of failure with respect to deferred compensation.

♦ **No Intentional Failures**.

♦ **Correction Effective** on latest of: adoption date, effective date, and date documents amended.

♦ **Some 409A Penalties May Apply** if corrected provision would have been triggered within certain period following correction.
Section 409A Document Error – Correctible Errors

♦ Impermissible definition of otherwise permissible payment event.

♦ Impermissible payment periods following a permissible payment event.

♦ Certain impermissible payment events and payment schedules.

♦ Failure to include six-month delay for specified employees.

♦ Provisions allowing impermissible initial and subsequent deferral elections.
Relief for Ambiguous Terms

Plan terms requiring payment “as soon as reasonably practicable” will not be a 409A document violation if 409A permissible payment event is treated as payment date.

Ambiguous payment events that can be interpreted to comply with 409A, example.

- “Acquisition” = Change in Control.

No plan amendment required.

No reporting to IRS required.

Erroneous payments are treated as 409A failures and corrected under operational error correction program.
Document Correction Example – Invalid Payment Period

Scenario: Plan provides for payment within 120 days after separation from service.

Correction: Amend plan to provide for proper payment period (90 days or less).

Potential Penalty:
- If any payment events occurred before correction (and correction was made soon after event).
- 50% of amount involved is subject to 409A additional 20% tax.
Document Correction Example – Invalid Payment Event

♦ **Scenario:** Plan provides for payment on earlier of separation from service and company’s IPO.

♦ **Correction:** Amend plan to remove improper payment event (company’s IPO) prior to event being triggered.

♦ **Potential Penalty:** If IPO occurs within 12 months after amendment, 50% of amount that would have been paid is subject to 409A additional 20% tax.
Correction of Section 409A Document Errors – Employer Reporting

- Company must attach statement regarding correction to its federal income tax return.

- Statement must also be attached in year after correction if any employees had to include an amount in income under correction.
Company must provide each employee affected by failure similar statement regarding correction.

Employee must file this statement with his individual tax return.

If employee had to include an amount in income under correction, statement must also be included with following year’s return.