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409A Basics | A Webinar Series

Code Section 409A: Revisiting the Basics

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Section 409A Background

- The American Jobs Creation Act of 2004 added section 409A to the Internal Revenue Code, effective January 1, 2005
- Notice 2005-1 was released in December 2004, establishing a “good faith compliance” period pending permanent regulations
- Proposed regulations were released in September 2005
- Interim guidance issued on special and transitional situations
- “Good faith compliance” standard through December 31, 2008
- Final regulations became effective January 1, 2009

Section 409A – Basic Provisions

- Section 409A provides strict timing rules for deferral elections, distributions, and funding of nonqualified deferred compensation
- Section 409A applies to amounts “deferred” after 2004; amounts generally “grandfathered” if vested by December 31, 2004
- Noncompliance triggers income inclusion of all amounts deferred under plans of same type; included amounts subject to a 20% additional tax, plus an additional “interest tax”

Section 409A – Basic Provisions

- Broad applicability – starting point is any legally binding right to taxable compensation in a future year
- Statutory exclusions for qualified retirement plans and bona fide vacation, sick, and compensatory time arrangements as well as disability and death benefit plans
- Relatively broad exclusions apply for “vest and pay” (short-term deferral) arrangements, certain nondiscounted stock rights, and limited involuntary separation pay amounts

Implementation Challenges

- Identifying affected arrangements – employer plans as well as individual agreements
- Benefit coordination – identifying and dealing with offsets between NQDC arrangements, including severance promises
- Living with the inability to remake or dispose of promises that employers would like to put behind them

Deferral Elections

- Deferral elections must generally be irrevocable and must be made in the taxable year before the services are performed
 - Includes election both as to the time and form of payment
- Elections for fiscal year–based compensation may be made by the last day of the prior fiscal year
- Elections may be made as late as six months before the end of the performance period for performance-based compensation, but specific requirements apply to meet the requirements to be treated as performance-based compensation

Deferral Elections

- Plan may permit a service provider to make a deferral election within 30 days after becoming eligible to participate, but only with respect to compensation for services performed after the election
- A service provider can make a deferral election with respect to compensation subject to a substantial risk of forfeiture up to 30 days after the grant if the service provider is required to perform services for at least 12 months after the date of an election
- Redeferral permitted, but must be for at least five years, with election at least 12 months before payment date
- To be used, deferral terms must be in the document and be section 409A compliant

Permitted Distributions

- Must be paid upon one of the following
 - Fixed date or schedule
 - Death or disability
 - Separation from service
 - Change of control
 - Unforeseeable emergency
- Any acceleration of payments generally prohibited
- Ability to renegotiate payment timing VERY restricted

Distributions on a Fixed Date or Fixed Schedule

- Plans may specify the calendar year or years in which the payments will be made, without specifying the date
- A fixed date or schedule may be triggered by an event that is subject to a substantial risk of forfeiture where the date of the event is unknown
 - e.g., payment due on attainment of performance goal will be paid in five annual installments beginning in the year following the change of control
- Any election as to timing of payment is subject to the same timing rules applicable to deferral elections

Important Exclusions

- Short-term deferral
- Involuntary separation pay
- Nontaxable benefits
- COBRA health benefits
- Certain outplacement benefits
- Moving expenses and loss on sale of primary residence
- Section 402(g) limit “catch-all”

Short-Term Deferral Rule

- Amounts that are paid shortly after vesting are not subject to section 409A – sometimes called the “vest and pay” exception
- Important exception for bonus, phantom equity, and long-term incentive plans
- Includes an amount received by the service provider by the later of:
 - 2 ½ months from the end of the service provider’s tax year when vesting occurred, or
 - 2 ½ months after the end of the service recipient’s tax year when vesting occurred

Short-Term Deferral Rule

- Late payment of such an amount is an automatic violation of section 409A if the plan does not provide a fixed date or year by which payments are to be made
- Accordingly, timely payment is critical
- Exclusion does not apply if the amount is further deferred
- Availability of an election to defer does not disqualify eligibility from exclusion if no election to defer is made

Short-Term Deferral Rule

- Generally, if one payment in a stream of payments is deferred compensation, all payments are deferred compensation
- However, if payments are designated as separate payments, some may qualify as short-term deferrals while later payments are deferred compensation
- Payments that may be made later than in the 2 ½–month window (e.g., payments due upon separation from service or discounted option exercise) are deferred compensation even if ultimately paid during the window

Substantial Risk of Forfeiture

- Generally, a requirement to perform substantial services (e.g., two years)
- Or a requirement for an individual or corporate performance goal to be satisfied
- Or a combination of service and performance
- Otherwise, the amount is forfeited if the service or performance condition is not satisfied

Exclusions for Separation Pay

- Involuntary separation and window programs, and certain good–reason separations, up to a limit:
 - 2x pay, capped at the section 401(a)(17) limit, and
 - Paid within two years from year of separation
- Certain expense reimbursements and in-kind benefits, so long as paid during the above two-year period
- *De minimis* amounts up to \$17,000 (indexed)
- Short-term deferral amounts (you can “stack” the exceptions)

Stacking Example

- If, due solely to involuntary termination on June 1, 2012, an employee becomes entitled to monthly payments equal to \$40,000 per month for 18 months, the total severance amount will exceed \$500,000. However, if the payments must be made on the last day of the month beginning in June 2012, the first nine payments (totaling \$360,000) will be excluded from section 409A under the short-term deferral rule (i.e., those payments will be made prior to March 15, 2013). The remaining \$360,000 fits within the involuntary termination exception since such payments are less than the \$500,000 limit (assuming also that two times the employee's annual compensation is at least \$360,000) and will be paid within the required time frame.
- Note that designation of separate payments is necessary to achieve this result!

Permitted Distributions – Recap

- Must be paid upon one of the following
 - Fixed date or schedule
 - Death or disability
 - Separation from service
 - Change of control
 - Unforeseeable emergency
- Acceleration of payments generally prohibited
- Ability to terminate nonqualified deferred compensation plans restricted
- Ability to renegotiate payment timing VERY restricted

Distributions on a Fixed Date or Fixed Schedule

- Plans may specify the calendar year or years in which the payments will be made, without specifying the date
- A fixed date or schedule may be triggered by an event that is subject to a substantial risk of forfeiture where the date of the event is unknown
 - e.g., payment due on attainment of performance goal will be paid in five annual installments beginning in the year following the change of control

Separation from Service

- Distribution trigger for section 409A deferred compensation
- Specific definition under regulations – generally 80% reduction in service level (versus trailing 36-month service period)
- Impact when six-month delay starts to run
- Can be difficult to determine if separation is not complete

Separation for Good Reason

- May be treated as involuntary separation
- The good–reason condition must require actions taken by the employer resulting in a material negative change in the employment relationship
- Review existing programs for other factors supporting equivalence of good reason with involuntary termination
 - Notice and cure

Plan Termination Distributions

- A plan may be terminated, and benefits distributed, following a corporate dissolution or if permitted by a bankruptcy court under conditions described in the regulations
- A plan may otherwise be terminated, provided the termination is not proximate to a downturn in the employer's financial health and all aggregated plans are similarly terminated
 - Payments upon termination may not be made any earlier than 12 months after all necessary steps have been taken for plan termination
 - All amounts must be distributed within 24 months following the plan termination
 - No new plan of the same type may be adopted for three years after the termination

Special Change-in-Control Issues

- Regulations provide special opportunities to terminate arrangements pursuant to a change in control (all plans of the same type for all participants experience a change in control)
 - Plan and all similar plans must be terminated within 30 days before or 12 months following the change in control
 - Plan participants must receive a distribution of their accrued account balances within 12 months following the plan termination
- Dealing with earn-outs and equity compensation promises
- Certain extensions of vesting (sometimes necessary to get the deal done)

Equity Compensation Highlights

- Stock rights
 - Relatively broad exclusion for nondiscounted options and SARs
 - Exclusion has detailed requirements
- Incentive stock options excluded (but watch out!)
- Restricted stock
- Phantom stock and restricted stock units (RSUs) – vest and pay?

Stock-Based Compensation

- Stock options and SARs are not deferred compensation subject to section 409A if:
 - Exercise price can never be less than the fair market value (FMV) of the underlying stock on the grant date
 - Stock right is granted on “service recipient stock”
 - Stock right does not include any deferral feature other than the deferral of income from the grant date until the option exercise date

Permissible Classes of Stock

- Stock must be common stock
- Any class of common stock may be used (e.g., voting or nonvoting)
- Cannot have a preference as to distributions other than distributions on such stock and distributions in liquidation
- Cannot be subject to mandatory repurchase (other than a right of first refusal) or a put or call right that is not a lapse restriction, UNLESS the price is at current FMV on the repurchase

Permissible Service Recipient

- Corporation for which the service provider provides direct services on the grant date, plus
- Any corporation in a chain of corporations and entities ending with the direct service recipient
 - Chain based on at least 50% ownership
 - Ownership threshold may be reduced to 20% where the use of such stock is for legitimate nontax business criteria
- No “brother-sister” or subsidiary options/SARs eligible—up the chain only

Valuation of Nonpublic Stock

- Nonpublic stock must be valued using a reasonable application of a reasonable valuation method
- Regulations specify criteria to consider
- No requirement to have an independent valuation
- Safe harbors for certain independent valuations, “closed-system” required repurchases, and certain valuations of closely held startups where valuation is performed by a qualified insider

Modification of Stock Rights

- Modification generally results in a new grant
- Modification is any change in the terms of the stock right that may give the holder:
 - a direct or indirect reduction in the exercise price of the right
- Changes that would meet requirements under section 424 rules for ISOs are not treated as new grants of rights
- Exercise period may be extended to the earlier of when the right would have originally expired or 10 years from the original grant
- Can extend term of underwater options (treated as new grant)

Extension of Stock Rights

- Extension beyond the LESSER of the original term or 10 years is generally treated as an “additional deferral feature” for the ORIGINAL grant date
- Effect generally will be to cause an automatic section 409A violation
- Most option extensions do not go beyond the lesser of the original term or 10 years, and extensions within that time frame do not cause a violation or treatment as a new grant

Documentary Requirements

- The deferred compensation arrangement must be in writing
 - May be in more than one document
 - Must set forth requirements regarding
 - *Amount to be paid or formula for calculating*
 - *Election requirements*
 - Both initial and redeferral

Documentary Requirements

- Document need not:
 - Reflect choices made during transition period
 - Contain provisions regarding accelerated payments otherwise permitted by the regulations
- A 409A savings clause probably should be included, but may not “save” you
 - Plan must contain all required terms and not contain impermissible terms, regardless of savings clause

Grandfather Rules

- Grandfathered arrangements
 - Cannot “materially modify” or lose grandfather protection
 - In general, a material modification exists only when a right is added, not when one is taken away
 - *Certain additions are acceptable*
 - More investment alternatives
 - Changes to stock rights that are not treated as new grants or additional deferral features

Documents Affected

- Deferred compensation arrangements and supplemental retirement plans
- Severance promises, including in employment agreements
- Guaranteed bonuses
- Discounted stock options or SARs
- Phantom stock, RSUs, and other equity rights
- Long-term incentive plans
- Annual bonus plans
- Split-dollar life insurance
- Taxable health benefit promises

Other Deferred Compensation Arrangements?

- Identify arrangements covering:
 - **Directors**
 - *Annual retainers*
 - *Guaranteed bonuses*
 - *Per-meeting payments*
 - **Independent contractors**

Plan Drafting Issues

- Benefit offsets
- Reimbursement and in-kind benefits
 - Any reimbursement must be for expenses incurred during the period of time specified
 - The amount of expenses eligible for reimbursement, or in-kind benefits provided, during a calendar year may not affect the expenses eligible for reimbursement, or in-kind benefits to be provided, in any other calendar year
 - The reimbursement of an eligible expense must be made no later than the last day of the calendar year following the year in which the expense is incurred
 - The right to reimbursement or in-kind benefits may not be subject to liquidation or exchange for another benefit

Plan Drafting Issues

- The employment agreement minefield
- Six-month delay requirement (must be in the document if it applies)
- Identifying affected documents (the population is bigger than you think) need to review everything not excluded by statute, but maybe those, too
- Tax gross-ups
 - Generally subject to section 409A
 - Can meet fixed schedule payment timing requirement if reimbursement for tax payments is required to be made no later than the end of the year following the year in which taxes are remitted

Correction of Operational Failures

IRS Notice 2008-113

- Limited opportunity to correct specified operational failures
- Does not expressly address “form” or documentary failures
- Relief only available if reasonable steps are taken to avoid recurrence of failure
- Relief for erroneous payment may not be available where service recipient is subject to substantial financial downturn

Correction of Operational Failures

IRS Notice 2008-113

- Availability of correction or terms of correction may be limited if affected service provider is an “insider”
- For this purpose, insiders generally include directors and senior management, determined under Securities Exchange Act rules (without regard to whether the company is public)

Correction of Operational Failures

IRS Notice 2008-113

- Availability and method of correction is generally based on the nature of the error and the proximity of the correction to the error (same year, next year, end of second year)
 - Errors can generally be corrected in the same year without additional taxes under section 409A
 - For noninsiders, it is possible to correct in the following year without additional taxes under section 409A
 - For insiders and noninsiders, corrections of violations of limited amounts and corrections made by the end of the second year following the year of error require a payment of the 20% additional tax only (avoiding the interest tax and aggregation rules)

Correction of Operational Failures IRS Notice 2008-113

- All corrections under the Notice entail some form of disclosure to the IRS
- Correction program is very mechanical and can be administratively complex

Correction of Document Failures

IRS Notice 2010-6

- Provides the opportunity to correct certain documentary failures
- Types of plan document errors eligible for correction include:
 - Ambiguous payment terms
 - Impermissible payout triggers and payout schedules
 - Violations of deferral election rules
 - Certain impermissible discretion to delay payments
 - Certain impermissible discretion to accelerate payments

Correction of Document Failures

IRS Notice 2010-6

- The particular plan document error must be described in the Notice to be eligible for correction
- Each specified error has its own particular correction methodology
- Wide range of categories of errors, correction methods, and severity of consequences
- Neither the service provider nor the service recipient may be under examination
- Must also correct any other similar plan document errors

Correction of Document Failures

IRS Notice 2010-6

- Adverse tax consequences may be triggered, even after correction, depending upon the timing of subsequent events
- For most plan document corrections, if payments are triggered within the 12-month period following the date of correction, 50% of the deferred amount will be subject to section 409A taxes
- Special relief is available for initial adoption of a new plan if corrected by the end of the calendar year or the 15th day of the third month following adoption
- Generally, must file notices of correction to the IRS with both the individual and the corporate tax returns

Supplemental Guidance Under Notice 2010-80

- Includes technical modifications to corrections guidance under Notice 2008-113 and Notice 2010-80
- By the end of 2012, transition period for correcting release provisions will lapse, so payments of deferred compensation conditioned on payment of a release should be fixed by the end of 2012 so as not to allow a service provider to control year of payment timing based on delivery of release.
 - Specify that payment date is not affected by release timing, or
 - Specify that where release delivery and nonrevocation period span two taxable years, payment will always be made/commence in second taxable year



Questions?

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