Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 3 -
Code Section 409A – Six Month Delay

By Andrew Graw and Megan Monson
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Andrew Graw: Welcome to the latest edition of Just Compensation. I'm Andrew Graw, I Chair Lowenstein Sandler's Employee Benefits & Executive Compensation practice group.

Megan Monson: And I'm Megan Monson. I'm Counsel in Lowenstein Sandler's Employee Benefits & Executive Compensation group. And we're your hosts today.

Andrew Graw: Today, we're going to focus on a subject that often arises and befuddles clients. It's the application of the six-month delay rule under Section 409A of the Internal Revenue Code. We find that clients are often surprised to learn that the six-month delay rule does not apply in many separation from service situations, even when it's involving senior executives who receive significant separation pay. In this podcast, Megan and I will explain exactly why that is and include some examples for you.

Megan Monson: So to get us started, I'll give you a little bit of insight into what is the six-month delay. In general, Section 409A of the Internal Revenue Code requires that deferred compensation payments to specified employees, and we'll get into what that is in a minute, that are made on account of separation from service do not begin until six months have elapsed since the date of separation. Andy, can you walk us through who is considered a specified employee?

Andrew Graw: A specified employee is any of the top 50 paid officers of a publicly traded company and its subsidiaries. So right off the bat, 409A's six-month delay rule only applies to publicly traded companies. It does not apply to private companies.

Megan Monson: And who's considered an officer for this purpose? And is there any sort of cap on the number of officers that are looked at?

Andrew Graw: So oftentimes, figuring out who an officer of the company is can be a challenge. It's not the same as an officer or even executive officer for purposes of securities rules. Instead, it's based on the definition of officer that's used for completely different purpose under the Internal Revenue Code. And that has to do with determining whether a plan is a top-heavy plan for purposes of the code. And that applies to non-public companies as well. So that makes the terminology used a bit of a muddle.

In determining whether or not someone is an officer, you look at their title, duties. It's a facts-and- circumstances-based analysis as to whether or not someone is functioning and has the authority of an officer. Whether or not they have the title of an officer is actually not that important. Somebody can be an officer for this purpose because of the authority and duties that they have, even though they may not have an officer title. On the other hand, somebody who has an officer title might not actually be an officer for this purpose because their duties and responsibilities and authority suggest that they're not an officer within the meaning of Section 416 of the code. As an example, a bank has many, many vice presidents. Many of those vice presidents might not be officers because a vice president of a bank may have limited authority. It does require an analysis for each company of who is an officer.

Megan Monson: And one thing I would add is this is something that, as Andy mentioned, needs to be examined on a facts-and- circumstances basis at the time the individuals are actually separating from service and determining whether or not the six-month rule applies. So somebody could join the company initially and not be acting with the authority of an officer, but as they grow in their role, they could be taking on more responsibility. That would sweep them into this requirement.

Andrew Graw: And I'll just add to that, that there is another complexity to this rule, which requires an employer to identify specified employees as of a given date and then that individual or that group of individuals remain specified employees for the following 12-month period, even if they're no longer acting as an officer. Simply because they're on that list, they remain a specified employee for the following 12 months. It's a little bit difficult to provide guidance on that per company, but the default rule is that if someone is a specified employee during a calendar year, then they're considered to be a specified employee for the following 12-month period that begins the following April 1.

Megan Monson: So we've gone into a little bit about what the rule is and who it applies to. But what are some typical situations where you actually see the six-month delay applying?

Andrew Graw: The most clear situation in which the six-month delay rule applies is for a garden-variety, deferred compensation arrangement where payment is deferred until separation from service. For example, a SERP or supplemental 401(k) or defined benefit pension plan that provides for payments upon a separation from service would invoke the six-month delay rule for those who fall within its ambit.

One other thing, Megan, I'll add to that is the six-month delay rule only applies to a separation from service. So if a payment is made as a result of the triggering of an event, like a change of control without a separation from service, or a fixed point in time, like a particular date, then the six-month delay rule would not apply because those would be triggering events that are not a separation from service.

Megan Monson: So I'm thinking a question that is raising in our listeners minds are, are these common arrangements, these supplemental employee retirement plans or deferred comp arrangements that delay payment to an actual separation of service? Do you see a lot of public company clients that have these type of arrangements?

Andrew Graw: Many public company clients have these kinds of arrangements. They have deferred compensation plans. They have supplemental plans for their key executives. Are designed to overcome the statutory limits of the Internal Revenue Code that apply to 401(k) and defined benefit plans.

Megan Monson: Okay, so it sounds like this is definitely something that comes up from time to time, so companies should be aware of. And since we've just focused about when this rule applies, on the flip side what are some circumstances where it does not apply?

Andrew Graw: As I said, one of the situations where it does not apply is where a distribution is triggered by something other than a separation from service. In those situations, again, because the payment is not triggered by a separation from service, the six-month delay rule does not apply.

Megan Monson: So in general, I know most employment agreements typically include language regarding the six-month delay, whether it's going to apply in practice or not. In general, how does this rule interplay with situations where executives have employment agreements under which they're entitled to severance?

Andrew Graw: This is actually the situation that is the most difficult to analyze in terms of the six-month delay rule. And it's also the one that clients misunderstand the most because one would normally think that if the CEO or another key executive were entitled to millions of dollars of severance that's obviously payable on separation from service, that the six-month rule would kick in. However, that's often not the case. And it requires an analysis of the arrangements that are in place for the executive. For example, every employment agreement with an executive who is among the 50 top specified employee group really must be scrutinized to determine whether or not the six-month delay rule applies in a given situation.

Andrew Graw: Here's essentially why. There are two overriding exceptions under 409A that could exempt payments upon a separation from service. One is called the short-term deferral rule, and the other is called the separation pay exception. Under the short-term deferral rule, amounts paid by no later than two and a half months after the year in which the amounts become vested are exempt. Under the separation pay exception, up to the lesser of two times the individual's average compensation or, at present, $580,000 can be paid as long as the amounts are payable within two years following separation from service and the amounts are paid solely on account of an involuntary termination of employment.

Megan Monson: For that purpose, what's considered an involuntary termination of employment?

Andrew Graw: Well, that's a great question, and it's one that also gives us difficulty in analyzing often. The reason is that many executive employment agreements include terms under which an executive is entitled to separation pay in the event of either an involuntary termination without cause or if the executive resigns for good reason. If the agreement provides for a payment, the separation pay, on any other event, then it does not qualify for the separation pay exception, and it probably will not qualify for the short-term deferral rule either.

The IRS in regulations under Section 409A provided a safe harbor definition for good reason. And it's a fairly strict definition that we find many arrangements don't adhere to. That doesn't mean that they won't qualify for either the short-term deferral exception or the separation pay section, but it is worth noting that it's outside the boundaries of the IRS definition of good reason.

Megan Monson: So for both of these separation pay exception and short-term deferral exception, if somebody's getting severance, I've heard clients mention that it's permissible to stack these two exceptions and that could be a way to avoid the six-month delay. Can you give us an example of how this would work in practice?

Andrew Graw: Yes. And that's exactly right. You're allowed to use both of those exceptions in order to take maximum advantage of them. Here's a couple of examples. In the first, let's say a CEO has an employment agreement providing for two times his base salary and bonus to be paid in a lump sum within 60 days following an involuntary termination without cause. Very simple. In that situation, it's clear that the severance is going to qualify, regardless of its amount, it's going to qualify for the short-term deferral exception because it's always going to be paid by March 31st of the year following the year in which the involuntary termination occurred, and therefore would not be subject to the six-month delay rule.

A more difficult example would be one where the CEO has an employment agreement providing for two times his salary and bonus. And let's say that totals $1 million to be paid in installments over a 12-month period following involuntary termination without cause. Under the separation pay exception, up to $580,000 is not considered deferred compensation. And further, because the CEO will receive only $500,000 in the first six months of the severance period, remember that it was $1 million in total paid in installments, so 500,000 will be paid in the first six months, that amount is less than the limitation on the separation pay exception of $580,000. So in effect, the CEO is able to get his severance payable on schedule under the separation pay exception without any delay at all. And you could say that some of that pay, depending on when the involuntary termination occurred, was also exempt under the short-term deferral rule. But in my example, it's not necessary to reach the short-term deferral rule as well.

Megan Monson: So I think based on everything you're saying, this is really facts-and-circumstances based. And I know a question that I see come up often is either clients ask do they really need the 409A boilerplate in their employment agreements? I think the answer always is yes. You're not going to know at the time the agreements entered into whether or not you're going to need to take advantage of the six-month delay rule or not, so it's a safer course of action just to include it.

Andrew Graw: It's also very important to make sure that employment agreements and other documents that provide for separation pay address the question of whether or not a six-month delay will apply in the event that a trigger should happen. The reason is that, as I said earlier, the separation pay exception and short-term deferral exceptions apply only if there's an involuntary termination and only if the documents allow for payment due to an involuntary termination. Even if it's very clear that the executive was terminated without cause and it was involuntary, if the documents provide for the same separation pay to be paid on other events besides an involuntary termination, then the short-term deferral and separation pay exceptions won't apply.

Megan Monson: And another point to add to that is making sure your documents have separate payment language because if there are going to be payments made in installments, that would allow you to take advantage of the stacking exceptions that Andy was talking about earlier. So it's just another way to make sure that you're taking advantage of all of the different ways to be exempt from 409A.

Andy, are there any other pitfalls that we haven't yet talked about for failing to treat amounts under the short-term deferral or separation pay exceptions that companies should look out for or plan for as they're drafting employment agreements?

Andrew Graw: There's pitfalls for this almost every which way you turn, so it's very important that clients really examine their employment agreements and make sure that work for purposes of avoiding the six-month delay. There can be a lot of pain and aggravation in finding out that the six-month delay applies when no one was expecting it to. They may also wish to provide in their agreements for interest to be paid on amounts that are delayed. That's a point of negotiation. There's no requirement to provide interest, but interest can be provided in the event that there is a six-month delay.

Megan Monson: Another question that comes to my mind is if there is a six-month delay and the company fails to comply with that, what's the risk?

Andrew Graw: The risk could be significant, not so much for the company, but for the individual. 409A is interesting in that it assesses a 20% penalty tax on the individual rather than the employer that created the document and administers it. So if the payment is paid earlier than the six-month delay rule or conversely if the amount should have been paid without a six-month delay but it is nonetheless delayed for six months, there can also be a violation of 409A in that situation as well. So it can get you coming and going. It's really important to evaluate what the correct payment timing is and apply it accordingly because it would be terrible from everybody's standpoint for an individual to be faced with a 20% penalty tax that was totally unexpected.

Megan Monson: Of course. And companies don't want to have unhappy executives, so in everyone's best interest to make sure that it's compliant. Do you have any other practical tips or considerations to share with our listeners before we wrap up?

Andrew Graw: Only more of what we've already discussed, and that is to really check documents. It's important to check documents early before a separation from service occurs. It may be possible to modify them in some manner in order to make sure that they will qualify for one of the exceptions we've talked about. If the definition of good reason is insufficient in comparison to the IRS safe harbor definition of good reason, it may be that there's an opportunity to adjust the agreement so that it will satisfy one of those exceptions.

Well, we hope that we've given you some insight into the application of the six-month delay rule today. There are many additional nuances to the rule. For example, how to apply the rule in connection with a change of control and how to determine those who are among the top 50 officers. If you have any questions about applying the rule in particular circumstances, please contact us. Thank you for listening. And please check out our other Just Compensation podcasts for guidance on a range of issues. If there are any topics that you would like to see us cover in the future, please let us know.

Megan Monson: Thanks so much for joining us today. And we hope to see you again next time.

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