

Code Section 409A - Six Month Delay

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**Employee Benefits &
Executive Compensation**

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■ Section 409A - Generally

What is Section 409A?

- Internal Revenue Code Section 409A, plus regulations and IRS guidance (lengthy, complex regulations on non-qualified deferred compensation).
- Deferred compensation is a legally binding right to compensation that is or may be payable in a future year (subject to numerous exceptions).
- Violation can result in the imposition of a 20% penalty tax and interest charges on the employee and early payment of taxes.
- Permitted corrections are extremely limited.
- Sets **time** and **form of payment** restrictions on non-qualified deferred compensation.

■ What is Non-qualified Deferred Comp?

409A impacts a wide variety of deferred and equity compensation arrangements, including:

- **Traditional salary, bonus and fee deferral arrangements (not paid within 2 ½ months following the year earned)**
- **Supplemental 401(k) and retirement plans (SERPs)**
- **Severance and change in control arrangements**
- **Stock appreciation rights, restricted stock units and phantom stock**
- **Consulting and retention agreements**
- **Discounted stock options**

■ Arrangements Not Subject to 409A

- Plans that qualify under Section 401(a) of the Code, including 401(k) plans and traditional pension and profit-sharing plans.
- Stock options issued with an exercise price equal to the underlying stock's fair market value on the date of grant.
- Restricted stock.
- Profits interests and capital interests (LLCs only)
- Bonuses and other compensation that must be paid within 2 ½ months following the end of the calendar or fiscal year in which it vests.
- Employee stock purchase plans (under Code Section 423).
- Certain severance plans under collective bargaining agreements or which cover only non "key-employees".
- SEP/SIMPLE plans, vacation leave, sick leave, disability/death plans.
- "Grandfathered amounts".

■ Short-Term Deferral Exception

- There is an exception to Section 409A for “short term deferrals”
- Payments qualify as "short term deferrals" if they must be paid no later than two and one-half months after the end of the taxable year in which the right to payment is no longer subject to a “substantial risk of forfeiture” (normally March 15 of the year following the year of “vesting”).
- A “substantial risk of forfeiture” means that the payment is conditioned on continued employment or something related to the purpose of the compensation (such as achievement of performance goals), and there is a real risk of forfeiture.
- To qualify as a short-term deferral, the payment must actually be paid by the end of the applicable two and one-half month period.

■ Separation Pay Exception (cont'd)

- Separation pay provided in connection with an involuntary termination is excepted if and to the extent that:
 - The payments do not exceed 2x the employee's annual compensation for the year preceding the year of termination (or, if less, 2x the compensation limit under IRC 401(a)(17) for the year preceding the year of termination; \$290,000 for 2021), and
 - The amounts are paid by December 31 of the second year following the year of termination, and
 - The individual can only be entitled to the payments due to an involuntary separation from service

■ Six Month Delay

- A 6-month delay in payment of deferred compensation is required for distributions made on account of the separation from service of a “specified employee” of a publicly-traded company.
- A “specified employee” is an employee who is a “**key employee**” for purposes of determining whether a tax-qualified plan is top-heavy (*e.g.*, any of the highest-paid 50 officers of the company earning in excess of a dollar amount (\$185,000 for 2021)).
- Status as a “specified employee” is based on a 12-month period ending **on a date specified by the employer**. Employees who meet the top-heavy requirements during that 12-month period are considered “specified employees” for the 12-month period beginning on the 4th month following the end of the 12-month period.

■ Examples

The following examples assume the following for a public company:

- CEO's annual base salary is \$500k
- CEO has an employment agreement providing for severance equal to 2x his base salary if he is involuntarily terminated without cause or due to a resignation for an IRS compliant definition of "good reason".

Example 1:

If CEO's severance is payable in a lump sum, then all of the severance can be paid without a 6-month delay because the severance is exempt from 409A as a "short term deferral" (see Slide 3).

Example 2:

If CEO's severance is payable in installments over a 12-month period, then all of the severance can be paid without a 6-month delay based on the separation pay exception (see Slides 4 and 5). Here's why:

The separation pay exception covers up to \$580,000 of severance. During the first six months of the severance period, CEO will receive \$500,000. Since that is less than the maximum separation pay exception amount, CEO can receive that amount without regard to the delay. The remainder of the severance will begin six months after separation from service anyway so CEO experiences no actual delay in payment.

■ Examples Continued

Example 3:

Let's assume the same facts as in Example 2, but the CEO's severance is 3x (or \$1.5 million) payable in installments over a 12-month period (\$125,000 per month). Let's also assume that CEO's separation date is October 1, 2021.

In this case, he would receive half of the severance (\$750,000) over the first six months of the severance period, which exceeds the \$580,000 maximum amount that can be shielded by the separation pay exception.

However, 5-1/2 months of severance (\$625,000) will be paid on or before March 15, 2022 and qualify for the short-term deferral exception. By "stacking" the separation pay and short-term deferral exceptions, CEO can receive all of the \$750,000 he is scheduled to be paid during the first six months after his separation from service and the remainder of the severance will begin six months after separation from service anyway so CEO experiences no actual delay in payment.

Example 4:

Let's assume the same facts as in Example 2, except that CEO's employment agreement provides that severance could be triggered if he resigns because the company is no longer a public company. In this case, the separation pay and short-term deferral exceptions will not apply because the severance is payable for a reason not limited to an "involuntary termination". Note that the exceptions will not apply because of how the employment agreement is drafted even if the CEO is involuntarily terminated for a different reason.