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

Episode 35 – Deferred Compensation: A Primer on Section 409A of the Code and Why it Matters

By Darren Goodman, Megan Monson, Jessica I. Kriegsfeld

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Jessica Kriegsfeld: Welcome to the latest episode of Just Compensation. My name is Jessica Kriegsfeld and I'm an associate in the firm's Employee Benefits and Executive Compensation Practice Group.

I'll turn it over to Darren and Megan to introduce themselves.

Darren Goodman: I'm Darren Goodman. I'm the Vice Chair of the firm's Employee Benefits and Executive Compensation Practice Group.

Megan Monson: And I'm Megan Monson. I'm a partner in the same practice group as Jessica and Darren.

Jessica Kriegsfeld: Today's discussion will focus on Section 409A, a lengthy and complicated tax code provision that governs non-qualified deferred compensation. The goal of our discussion is to provide a high-level overview of Section 409A, when it applies, how to comply with or be exempt from 409A, and what each of those situations means, and the implications of noncompliance.

As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if you wish to adopt an arrangement that provides for a potential deferral of compensation. Let's start with the basics. Darren, what is Section 409A?

Darren Goodman: 409A is a very complicated tax code provision in the internal revenue code that regulates nonqualified deferred compensation. So what exactly is nonqualified deferred compensation? There's a lot that goes into it, but at a high level it can be any arrangement where there's a legally binding right to compensation in a future year. That means potentially sale bonus arrangements, a phantom stock arrangement. Severance can be nonqualified deferred compensation. If there's a deferral of payment of base salary or bonus. There are other non-obvious ways whether you could have nonqualified deferred compensation such as a stock option with an exercise price less than fair market value on date of grant. Or a more traditional example is a supplemental executive retirement plan that allows senior executives to defer compensation that they would otherwise be paid until usually at or after the time of retirement. And it doesn't cover arrangements that are tax qualified. So a 401k, for example, is a qualified plan. It is outside the scope of 409A.

So if you have an arrangement that is nonqualified deferred compensation, it's not inherently a problem. What it means is that it has to be structured in a way that either complies with section 409A or is it exempt from section 409A. We'll talk about what each of those mean in a minute.

And just at the outset, the reason that we care so much about 409A compliance is that violation of 409A can have draconian tax consequences, including accelerated income tax, meaning people can be taxed on deferred compensation even if they haven't actually been paid it yet. And then on top of that, the employees can have a 20% penalty tax on top of regular income tax, and interest. Those are pretty bad outcomes for employees and it's really important to avoid them if possible.

Jessica Kriegsfeld: Megan, what does it mean for an arrangement to be exempt from 409A?

Megan Monson: So at a high level, it means that Section 409A does not apply to a particular arrangement. That said, it doesn't mean that 409A can be ignored entirely, but it does mean that there's a lot more flexibility in terms of how the arrangement is structured with respect to timing of payment and potentially making changes.

So certain arrangements are just generally exempt from 409A, and some common examples are stock options for common stock that are issued with an exercise price equal to fair market value on the date of grant. This is different than in the money stock options that Darren mentioned that would be subject to and required to comply with 409A. Other common arrangements that are exempt from 409A are profits interests, capital interest, restricted stock, potentially restricted stock units, although care must be taken because they may be structured to either be exempt from or compliant with 409A depending upon how they're structured.

Bonuses or other compensation that's paid out within two and a half months following the year in which it vests, which is commonly known as the short-term deferral period would be an arrangement exempt from 409A, or if continued employment is required through the date of payment, which is known as creating a substantial risk of forfeiture, those are other common ways that bonuses or other compensation would be structured to be exempt from 409A. Severance plans that are paid out within that short-term deferral that I just mentioned are exempt from 409A, as well as severance plans that are structured to fit within a special separation pay exception under the 409A rules that we're not going to get into detail about here. Tax qualified employee stock purchase plans are also exempt from 409A.

And certain arrangements with independent contractors can be exempt from 409A. And the nuance here is the independent contractors have to satisfy a specific test under 409A in order to be exempt from its requirements. So at a very high level, the requirements for the independent contractor to be exempt from 409A are they cannot be providing management services. So you have an independent contractor who's doing a role that's akin to manager, C-level executive, anything like that, you're already outside the scope of this exemption. The contractor also has to provide significant services in the same trade or business to two or more unrelated parties. And the safe harbor for significant services to or more related parties also requires that no single client accounts for more than 70% of the contractor's total revenues for providing such services for a taxable year. So really the independent contractor exception to be exempt from 409A is intended to be independent contractors who are in fact that and are in the business of actually providing services to a wide variety of clients in a particular industry.

There are some other exemptions from 409A, although less common such as accrual method taxpayers. And one really important thing to mention is that even if an arrangement is initially structured to be exempt from 409A, if there are changes being made, the 409A impact needs to be considered. So for example, if a stock option when it's granted is initially exempt from 409A because it's granted at the current fair market value of the company, reducing the exercise price is treated as a new grant for 409A purposes, and so you need to make sure that that doesn't create any 409A issue.

There are other situations. So again, it's really just important to be mindful of any potential deferred comp arrangement, if you're making changes, reviewing it for 409A compliance.

Darren Goodman: I wanted to highlight a couple aspects of that Megan. So one is you mentioned stock options for common stock that are issued with an exercise price of at least fair market value. And that's the reason such emphasis is put into getting 409A valuations and making sure that exercise prices are set properly. It's to make sure that the options can fit into this exemption from 409A.

And the other one that you've mentioned is bonuses that are paid within two and a half months after a year end. So commonly you'll see employment agreements offer letters that provide for payment by March 15th of the following year, and that's driven by this 409A deadline.

Jessica Kriegsfeld: If an arrangement must comply with 409A. What does that mean?

Darren Goodman: So what that means in plain English in general is that the time of payment has to be set at the time that the employee gets the right to the non-qualified deferred compensation. And 409A regulates the times of payment. So for example, non-qualified deferred compensation can be paid out on a change of control. It can be paid out on a separation from service. It could be paid out on the earlier of a change of control or separation from service.

Aside from a change in control event or separation from service, other permitted payment events include a fixed date, which can be as broad as a single calendar year. You could have non-qualified deferred compensation, for example, that's paid out in 2026. You can also pay out on someone's disability or death. Usually those aren't too appealing for employees to have to wait until they're disabled or to die in order to get paid out, or on vesting. So that's the universe of potential payment events.

The big gap here is that an IPO will not normally be a permitted payment event. So if you have deferred compensation and it's payable on an IPO, absent some sort of other extenuating circumstance, like one of the exceptions that Megan mentioned, there's going to be a 409A issue.

Once the agreement is entered into, companies and employees should take the approach that they're locked in. If you have an arrangement that is payable on a change in control and the company decides it wants to pay it out earlier,

Unless you fit into an exception, and those exceptions are relatively narrow, there's going to be a violation of 409A. On the other hand, if you have an arrangement that you want delay, for example, you have a bonus payable at 2026 from my example, if you get to 2026 and the company doesn't have the cash, delaying that payment's going to be a 409A issue unless you can fit it into an exception. So do not count on being able to change non-qualified deferred compensation. That's the key takeaway because the rules have some flexibility, but it's relatively limited.

And the other point I wanted to make is that 409A requires both documentary and operational compliance. So the agreement when it's created needs to have terms that work under 409A, and then the company actually needs to operate the arrangement in accordance with that agreement. If the document is fine, but there's an error, for example, at the company level and they don't pay out at the right time, there can be a 409A issue. I mean these are all facts and circumstances that can get very technical, but big picture, it's not just getting your document right, and it's not just operating it right, it's both.

Megan Monson: Yeah, and that's a really important point that you make Darren. In particular with respect to the documentary compliance, we often see companies who enter into arrangements on their own without the advice of counsel, drafting arrangements that may be intended to but do not comply with the rules of 409A, and then it becomes a potential issue of what could be done after the fact to fix those arrangements. And so it really is important for both of those reasons to consult with proper counsel if you're entering into any arrangement that has the potential for the deferral of compensation because these rules are very strict and need to be followed very carefully.

Jessica Kriegsfeld: Megan, what are some common 409A issues that you see?

Megan Monson: I think the biggest thing that comes up is trying to accelerate or delaying the timing of any payment. And in particular, I think one, if companies are not aware of this limitation, either having that hardwired into the arrangement in a way that's impermissible under 409A is problematic or trying to do something after the fact that runs afoul of the terms of the arrangement. And so again, I think it strikes the importance of one, if you're entering into any arrangements that are deferred compensation, having eyes wide open and knowing that there are limitations to being able to make changes to any sort of payment timing thereafter is critical.

Another common issue we see is phantom partnership or stock interest that do not comply with the timing requirements of 409A, in particular if they are intending to be deferred compensation, meaning that they're required to comply with 409A, but they're drafted in a way that do not align with one of those permitted payment events that Darren mentioned, that would result in a 409A issue. And again, I think it strikes the importance of following those requirements and specific permissible payment events very carefully to avoid having an inadvertent footfall and violating 409A.

A couple of other things that we see come up, although albeit less frequently than those two issues, are elections to defer compensation. And there are strict rules under the 409A regulations related to electing to defer compensation to a later year. Generally, an election to defer compensation to a later year must be irrevocable and made in writing before the year in which the services are rendered. And I'll note that that is key. And so for example, if you want to allow an individual to delay payment of a bonus to a future year, that election needs to be made prior to the year which the bonus would relate to. And so there's a timing element involved in making sure that it is documented properly. So for example, for 2024 services, these elections would've had to be made by December 31st, 2023.

Another thing that we see come up in particular for early-stage companies or as a result of the current economic state of affairs is accruing unpaid base salary. And so again, making sure that if there is a desire or a business need to try to accrue unpaid base salary, making sure it's done in a fashion that is compliant with or exempt from 409A.

Darren Goodman: Megan, I think a general theme here is advanced planning.

Megan Monson: I couldn't agree more.

Darren Goodman: Because if you consult with counsel and because you want to defer base salary, there's some pitfalls there, and it's always easier to structure these things in advance than after the fact, look back and analyze for any compliance. So you can't over emphasize the importance of consulting with counsel beforehand, before doing any of these types of things.

Megan Monson: Yeah, I agree. And I think often companies are not aware of the complexities or the downfalls for failing to comply with these rules, and so just being educated and aware that these limitations are out there should be enough to raise the radar, "Hey, let me give my counsel a call, see if plan on doing can work, and if so, how do we need to paper this properly?"

Jessica Kriegsfeld: What are the tax consequences for non-compliance with 409A?

Darren Goodman: So in short, potentially severe. So I alluded to them at the outset. Big picture, if an employee has deferred compensation that violates 409A, they will be taxed starting in the year then the deferred compensation vests, they'll be taxed on the fair market value as of December 31st of that year. They will also have interest. And often 409A issues are not discovered until years later, so the interest can be substantial. There will be a 20% penalty tax on top of the regular income tax and interest. And for those people in the state of California, there's an additional 5% state level penalty tax. Then if the deferred compensation increases in value a year over here, that increase will be included in income, and subject to the tax, and penalties, and interest. So it can be quite a bad outcome.

Those consequences are all on the employee, the one paying the taxes, but this is not purely an employee issue. Legally, if a company has an employee with compensation that violates 409A, the company has an obligation to report that on the employee's W2 at the end of the year, and they've also got an obligation to withhold on the income tax that is due, not the 20% penalty tax. If the employee doesn't pay the tax because it's still their responsibility, the company can be liable for the amounts that it should have withheld but didn't. So that's a direct potential exposure for a company.

If you are a company that is seeking to raise money or to sell, 409A is absolutely something that will be diligenced. And a buyer could ask for a special indemnity. They could ask for purchase price reductions. They could make other asks if they think there are 409A issues.

And then practically a company that has employees with a tax problem, it's just not a good situation to be in for the company. I mean, you don't want disgruntled employees in most instances. And the employees might look to the company to make them whole for the taxes and the penalties that were incurred due to the violation. And if a company wants to do that, it's just like any other compensation, you got to in itself will be taxable income, so you'd have to gross up that payment to truly make the employees whole, and it could become quite costly.

The IRS has issued guidance on how to fix certain 409A issues, not all of them. Sometimes the issues are caught in time, but oftentimes they're not because the deadlines can be quite tight. For insiders, the senior people, the deadline is often the end of the calendar year that the failure occurred. For your non insiders, often it's the end of the following year. And if you don't know if the issue until years later, it could be too late.

There are other potential fixes outside of the IRS correction procedures, but it really requires a detailed analysis and not inexpensive either, so it will often be a lot more cost efficient to plan in advance and to structure properly in advance rather than going back and trying to clean it up later.

Jessica Kriegsfeld: Megan, are there any other 409A considerations?

Darren Goodman: I'll just briefly mention that these issues often come to light in the context of an M&A transaction, or a situation where you have investors coming in and diligencing a company. And depending upon again what's found, the risk and exposure can be significant. And that coupled with the fact that the ability to correct can be limited, and in certain circumstances can only be done in a particular timeline it's really important to have these arrangements structured properly at the onset. Again, because if it's something that comes to light in the context of a deal, if it comes to light in the context of a deal, depending upon the issue and the significance, that could be material to the transaction and have potential negative implications.

The last thing I'll mention is the arrangement could be subject to ERISA, the Employee Retirement Income Security Act, and so that's just something else to be aware of when adopting these types of arrangements. And again, is another reason that highlights the importance of active planning and involving counsel early to ensure that you're complying with the tax code and any other applicable legal requirements.

Jessica Kriegsfeld: As you heard today, Section 409A is a complicated tax code provision with many nuances to navigate, and determining when it applies and how to ensure compliance. We hope that this episode provided you some food for thought and to make you aware of the importance of structuring any non-qualified deferred compensation agreement properly.

This episode is intended to be a high-level overview but is by no means an exhaustive discussion.

Thanks for joining us today. We look forward to having you back for our next episode of Just Compensation.

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