The Impact of Section 409A on Employee Compensation Arrangements - You Can Run, But You Can’t Hide

Originally published in Employment in the Law - Winter 2012

February 28, 2012

Does the mention of "deferred compensation" and Section 409A of the Internal Revenue Code ("Section 409A") cause you to break out in hives and immediately call your benefits lawyers? If so, you should be congratulated because you are way ahead of the game. You have overcome the first of many Section 409A hurdles by recognizing that a Section 409A issue – one which could have serious repercussions on your employees and your company – has been implicated. There is no doubt that Section 409A is a complicated area for employers, and one that is commonly overlooked. This article will help you identify some of the everyday employment issues that implicate Section 409A, as well as the consequences for failing to comply.

What is "Deferred Compensation?"

Deferred compensation generally arises in situations where a "service provider," such as one of your employees or independent contractors, has a legally binding right (under a benefit plan, employment agreement or other arrangement) in one tax year to receive compensation, where the compensation may not be payable until a later tax year. For example, if an employer enters into an employment agreement in 2012 that provides for severance in the event of termination, and a termination and resulting severance could occur after 2012, the severance amount constitutes deferred compensation unless it qualifies for an exception to Section 409A. Similarly, if an employer offers a performance-based bonus, payable in April of each year for work that was performed during the preceding year, Section 409A may apply.

In addition to severance and bonuses, deferred compensation can also include, for example:

- supplemental executive retirement plans (SERPs);
- excess benefit plans;
- salary and bonus deferral arrangements;
- taxable expense reimbursement arrangements (such as reimbursement for moving expenses);
- certain taxable in-kind benefits (such as company-paid automobiles and club memberships);
- certain equity-based compensation (including, for example, discounted stock options and stock appreciation rights, non-discounted stock options and stock appreciation rights with additional deferral features, restricted stock units and phantom stock);


- change in control awards;
- commission arrangements; and
- retention arrangements.

What Does Section 409A Require?

Section 409A generally provides that a "nonqualified deferred compensation plan" must comply with various rules regarding the timing of deferrals and distributions. All non-exempt deferred compensation arrangements must be in writing. Among other requirements, three key features of Section 409A are as follows:

1. Timing of deferral elections or designation of time and form of payment – Elections or designations regarding the time of payment (e.g., at separation from service or in a specified year) and form of payment (e.g., lump sum or installments) generally must be made prior to the beginning of the tax year in which the services giving rise to the payment will be performed, or must be specified at the time the agreement or arrangement granting the right to the compensation is first entered into. For example, if an employee elects to defer compensation that she will earn for services performed during the 2012 calendar year, she must have made such election, in writing, by no later than December 31, 2011. Likewise, if a bonus is subject to Section 409A and relates to services to be performed in 2012, the time and form of payment must have been designated by December 31, 2011 (even though the employee could not elect the time of payment).

2. Acceleration and further deferral of benefits – Once the time and form of payment are properly established, the deferred compensation arrangement must not permit the acceleration of the time or schedule of any payment thereunder (except under limited circumstances). Additionally, once the time and form of payment are
properly established, the plan must not permit the further deferral of any payment (except under limited circumstances). These rules generally prevent an employee or other service provider from manipulating the timing of income inclusion. Those rules can inadvertently be violated by changing the time or form of payment when restating an existing plan or agreement or substituting one type of payment for another.

3. Timing of distributions – The amounts deferred must be payable only upon separation from service, a specific date or time, disability, change of control, or unforeseeable emergency (as each of those terms is defined under Section 409A), or death. Ensuring that the payment event complies with Section 409A can be tricky. For example, with severance that is subject to Section 409A, the time of payment generally cannot depend on the timing of the employee’s execution of a release. In that case, the payment trigger would be the release and not the separation from service. If an employment agreement providing for severance states that severance will be made within thirty days after the employee signs a release, particularly when there is no outside time period for signing the release, the employee could control the time of payment (and the income event) by holding the release until the first day of the next year so that he or she is paid in the next tax year.

If the employer is publicly traded (or is related to a publicly traded entity), special additional timing rules apply to amounts that are payable to a "specified employee" (generally employees who are among the 50 highest paid officers and certain shareholders) in the
event of a separation from service. This rule generally requires that any deferred amounts payable upon a separation from service be delayed for six months after the separation from service (or until the specified employee's death, if sooner). This rule was implemented to prohibit executives from causing the employer to pay their deferred compensation shortly before a significant economic downturn (or insolvency) of the company.

There are several exemptions from Section 409A and many arrangements can be structured to fit within an exemption. However, a discussion of the exemptions is beyond the scope of this summary.

What are the Consequences of Not Complying With Section 409A?

The consequences for failure to comply with Section 409A are severe, particularly for the employee. If at any time during a given taxable year a nonqualified deferred compensation arrangement fails to meet the requirements of Section 409A (either in form or in operation), the following adverse tax consequences will apply:

1. **Immediate Income Inclusion** - all compensation previously deferred is included in the employee’s gross income to the extent that the amounts are vested (even if not yet received), provided the amounts have not previously been included in gross income;

2. **20% Penalty** – the employee must pay an additional 20% income tax on the amount required to be included in income above (in addition to regular income taxes on such amount); and

3. **Interest** - the employee must pay interest (at 1% above the normal underpayment penalty rate) based on the underpayment that would have occurred had the deferred compensation been includible in income in the year first deferred (or, if later, the first taxable year the deferred amounts were vested).

The consequences are compounded by the fact that a failure in one arrangement may taint other...
similar arrangements the service provider has with the company.

Although the tax consequences described above fall on the employee, employers may still be responsible for failing to withhold and pay all federal, state and local income taxes. Thus, both parties have a vested interest in making sure that any arrangement that results in the deferral of compensation is either exempt from, or in compliance with, the requirements of Section 409A.

In conclusion, Section 409A’s requirements, exceptions, and exclusions are very complex. Therefore, if you are structuring compensation arrangements you should immediately consider that Section 409A may apply. Troutman Sanders LLP’s Compensation & Employee Benefits group can help you avoid Section 409A liability and potentially help you structure the arrangement so as to avoid Section 409A altogether.

Related Practices and Industries

Labor and Employment