Episode: *Employee Benefits and Executive Compensation: Preparing for 2027* – 409A Primer
Hosts: Lori Basilico and Josh Gelfand
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Josh Gelfand (00:05):
Hello everyone, and welcome to our podcast series, *Employee Benefits and Executive Compensation: Preparing for 2027*. I'm Josh Gelfand, a partner in the Executive Compensation and Employee Benefits Group at Troutman Pepper Locke in New York. And I'm joined by my partner today, Lori Basilico. So, Lori, I'll let you introduce yourself.

Lori Basilico (00:24):
Great, thanks, Josh. I'm a partner in the Employee Benefits and Executive Compensation Group located in Providence, Rhode Island. And so today we're looking ahead to 2027 and doing a high-level review of Internal Revenue Code Section 409A, what it is, why it's here, and key points around 409A that companies and practitioners should be aware of. Our goal is to help you think strategically about how to position your organization and your plans for awareness and compliance with this complex section of the code.

Josh Gelfand (00:56):
All right, well, that's a great intro. Thank you, Lori. And I think let's just jump into it. I'm sure everyone's chomping at the bit to hear about 409A. So, I think the first thing we should talk about is what is 409A? Why does it exist? How did it come about? What is it supposed to do?

Lori Basilico (01:13):
Right, so Section 409A was enacted in 2004, so over 20 years ago, as part of the American Jobs Creation Act, born directly out of the corporate scandals of the early 2000s where top executives were able to accelerate and cash out millions of dollars in deferred compensation just before the company collapsed and went into bankruptcy, leaving ordinary employees and shareholders with basically nothing. So, Congress responded by creating a comprehensive framework that sets the rules for when an employee or service provider can defer receiving income and when that income will actually be taxed. So 409A imposes strict requirements on the timing of deferral elections, the permissible triggering events for distributions, and the prohibition on acceleration of payments. The stakes for getting it wrong are steep. Non-compliance results in immediate income inclusion, a 20% excise tax, and additional interest penalties on top of ordinary income tax. So that's why careful planning and structuring of deferred comp arrangements is essential.

Josh Gelfand (02:17):
So that's kind of a background, but what counts? You mentioned non-qualified deferred compensation. What is that? What falls under the rules?

Lori Basilico (02:24):
Non-qualified deferred comp under 409A is very broad. It covers any arrangement where an employee, whether it's a service provider, a director, an independent contractor, or a consultant, has a legally binding right to compensation in any one year but does not actually receive it until a later year. This is a deliberately wide net. It captures traditional executive deferred comp plans where an employee voluntarily elects to set aside a portion of their salary or bonus to be paid out at retirement or another future date. But it goes well beyond that. Supplemental Executive Retirement Plans or SERPs are covered. So are certain severance arrangements, particularly those that provide payments contingent on signing a release or that extend beyond what a broad-based workforce program would offer. Even certain bonus arrangements where the right to a bonus is earned in one year but payment is delayed until the next can fall within Section 409A's reach if they're not carefully structured to fit within an available exception. What surprises most people is just how many common arrangements are swept into the definition. Stock appreciation rights that are not properly structured can constitute non-qualified deferred compensation. So can discounted stock options, meaning options granted with an exercise price below the fair market value of the stock on the date of grant. And certain separation pay arrangements, consulting agreements with former employees, and even some reimbursement plans can implicate 409A if they're not designed correctly. However, not all arrangements that defer compensation are subject to 409A. Certain plans and arrangements are specifically excluded from its reach, including tax-qualified retirement plans such as 401(k) and pension plans, 403(b) tax-sheltered annuities, 457 eligible deferred comp plans, bona-fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans. These plans are all excluded from 409A.

Josh Gelfand (04:25):
I think that's very, very helpful. And I want to just go back and dig down a little deeper into something you mentioned before, which I think is really important about what the implications are of 409A. So, it's a very... like you mentioned, it's got a very broad net of what it captures. And a lot of the risk, and I think what's important for people to be aware of and be mindful of, is that a lot of the risk and exposure falls on the service provider, meaning the individual employee or contractor who is rendering the services and receiving the compensation, although there are still risks for company, for service recipients in this. Right? So, as you mentioned, Lori, there's really two or three penalty implications. The biggest one that everyone is always mindful of is a 20% additional tax that's on top of every other obligation and tax that the people get paid in connection with the compensation. But in addition to that, there is income inclusion at vesting, and there is potential late payment interest and penalties. So, what that means is if you've got $100,000 of deferred compensation under a non-compliant plan, let's say it was going to

be paid in 2035, but it's vested, it's no longer subject to a risk of forfeiture in 2026. What that means is that if the plan is non-compliant in 2026 and it's vested... And the amount is vested, then even though you would otherwise be paid the amount in 2035, the IRS will treat it and require you to be treated as if you received that $100,000 of income today in 2026. That's the income inclusion component, plus an additional 20% tax. Now, let's say that it first vested in '26, but it's not actually discovered, you don't realize the problem, or there's an audit that brings it up in 2030. Well, then you should have had it included in '26. So now what you're paying is, you're supposed to have included it in '26, and now you're going to accrue interest for the late payments up until today, plus the 20% tax. The company is concerned and at risk because the company has a reporting and withholding obligation on that income inclusion. So, they're secondarily liable, presumably as the paying agent, secondarily liable for that improperly or missed withheld amount. So that's where the implication can come to the company, above and beyond the employee relations issues that arise with an employee finding out they're hit with a major tax. One thing to note, which is important is, the 20% additional tax that's levied on the individual service provider, there is no employer withholding obligation for that amount. So at least the company is not on the hook for failure to withhold on the 20% tax, just on the income inclusion amount. But these, as you can kind of see from this example, these amounts can be fairly substantial depending on how much money is at issue. And they often come up as deal issues in due diligence in M&A transactions, as well as just ordinary compliance reviews for companies. So, it's important to keep that in mind.

Lori Basilico (07:33):
The penalties are pretty severe, but there are ways to get out of 409A entirely. So, Congress and the IRS built in a number of exceptions that, if structured properly, allow the arrangement to fall completely outside of the statute and its harsh penalty regime. The first and perhaps most commonly used exception is the short-term deferral rule. Under this exception, if compensation is actually paid with no strings attached within two and a half months after the end of the taxable year in which it vests, it's not considered deferred compensation at all, and 409A simply does not apply. This is why many annual bonus arrangements are structured the way they are. If a bonus is earned and vested by December 31st and paid out by March 15th of the following year, it falls squarely within the short-term deferral exception. Likewise, if a bonus plan requires employees to be employed on the date of payment, it also falls within the short-term deferral exception, with being paid on the date that it vests. The key here is that there must be no substantial risk of forfeiture extending beyond that window, and the payment must be actually made on time and not just promised.

So, this short-term deferral exception is pretty commonly used, and we try to structure, if we can, most of our deferred comp arrangements to fall within the short-term deferral. Another major exception covers separation pay arrangements. This is where, if you have separation payments that are paid upon an involuntary separation from service, or in some cases a voluntary separation for good reason, that do not exceed two times the

employee's annualized compensation, capped at two times the Section 401(a)(17) limit for the year of separation. So, for 2026, that limit is $360,000, meaning that this separation pay arrangement can shelter up to $720,000 in severance, provided that the severance is paid out by the end of the second calendar year following the separation of service. And so again, this is another useful exception. A third important exception applies to stock options and stock appreciation rights. ISOs, Incentive Stock Options that meet the definition of 422 of the Code, are excluded from 409A by statute. So, this applies to non-qualified stock options and stock appreciation rights. They can be excluded from 409A, but only if the exercise price is at least equal to the fair market value of the underlying stock on the date of the grant, and the award does not include any additional deferral features. This is why getting the grant date valuation right, particularly for private companies where fair market value is not readily observable, is so critical. A discounted stock option, even one that was inadvertently discounted, loses the exception entirely and becomes subject to 409A at the moment of vesting.

Josh Gelfand (10:30):
Just to drive that point home, first on the exceptions, I think it's really critical because this is where a lot of the effort and the work is put in. And an interesting point to be aware of is that you don't necessarily have to pick one or another exemption. So, there's a kind of a slice and dice, or stacking as they call it, where you can actually potentially put a good amount of comp under the involuntary separation from service rule and then maybe fold another piece of it under short-term deferral. So, there might be opportunities to kind of layer one on top of the other with those types of exceptions, which can be very helpful.

Lori Basilico (11:07):
Right. No, I totally agree, Josh. The stacking exemptions are very important to allow for perhaps even a very large payment to get out of 409A entirely.

Josh Gelfand (11:18):
Yep.

Lori Basilico (11:19):
So, you are now subject to 409A. You can't find an exception. So, the next critical question is, when can the money actually be paid out? So, 409A has its own distribution rules, and non-qualified deferred compensation can only be paid out upon the occurrence of one of six specific triggering events, which are separation from service, disability, death, a specified time or pursuant to a fixed schedule, a change of control of the corporation, or an unforeseeable emergency. Each of these have a precise regulatory definition that must be carefully observed. Separation from service, for example, does not simply mean the day someone stops showing up at the office. The regulations define it based on a significant reduction in the level of services performed, generally a reduction of 20% or less of the average level of services over the prior 36 months. For specified employees of publicly traded companies - think the top 50 highly

compensated officers - there's an additional wrinkle. Payments triggered by separation from service cannot begin until six months after the separation date or, if earlier, the employee's death. This so-called six-month delay catches many people off guard and must be built into the plan from the start.

Similarly, a change of control is not just any transaction. It requires meeting specific ownership, asset, or board composition thresholds defined in the regulations. Unforeseeable emergency deserves special mention because it is frequently misunderstood. It covers severe financial hardship arising from an illness or accident, loss of property due to casualty, or similar extraordinary and unforeseeable circumstances beyond the employee's control. It is not a hardship withdrawal similar to what you would think of in a 401(k) plan. The amount that can be distributed is limited to what is reasonably necessary to satisfy the emergency, and a distribution is not permitted at all to the extent that the hardship can be relieved through insurance, liquidation, or other assets. In short, it's a narrow safety valve and not a broad escape hatch. So, we talked about 409A having certain timing rules and that it really prohibits acceleration. So, Josh, can you explain sort of the re-deferral rules and the timing rules and the prohibition on acceleration of non-qualified deferred compensation?

Josh Gelfand (13:42):
Yeah, definitely. I think this is a really important part to be mindful of. So, we're talking, we've said we know what deferred compensation is, we say when you're allowed to pay it, but when do you make those determinations and how does that all work? There's really, at a base level, there's two conceptual situations that come up. One is an initial deferral election, which is, as it sounds, the time that you first make a deferral under a plan, which can in some cases be if you've got... If we're entering into a contract today that's going to be deferred compensation, that's one. Or if there's a plan, say a bonus deferral plan or something of that nature, maybe there's a plan that people are already in and every year you make an election. Well, when do you make that election? When does it have to be made by? And so forth. And the second one is what we'll call subsequent deferral elections. And keeping in the theme of how 409A is intended to work, we have to remember, be mindful, and I think a kind of guiding light in a lot of this is 409A is supposed to minimize and reduce the ability to have discretion to change the timing of payment to allow for changes in the tax year in which the amounts are included in income.

And so, with that framework in mind, you look at the subsequent deferral rules. They say, well, we're going to let you make changes, but it's going to be really limited and it's only under a certain subset of permissible activities, and we're going to make it really hard for you to do that. So, we'll get into that in a second. So, for initial deferral elections, there's a lot of different specific rules around it, and I don't want to go too into the weeds on each one of the scenarios in which it can arise. But as a general matter, you set the timing of the payment, when the payment will be made, at the time that the legally binding right to the payment arises. So typically, if you have a deferred bonus or

if you've got a transaction bonus or something like that that's deferred comp, when you enter into the contract, you set that up. If you've got a plan and you get to elect, let's say, a portion of your compensation, let's say a salary deferral or a bonus deferral or something of that nature, the general rule is that it has to be made before the end of the year preceding the year to which the services relate. And so essentially that typically means that it has to be an irrevocable election that's made before 1231 of the year that the amounts paid are paid by, not to be clear, before the amount is earned. So, if you've got a salary deferral election for some work, for salary in '27, it's got to be made by 2026 end of year.

You can't say, "Well, I'm not... I'm deferring the salary for June '27, so I have to just elect it before then." It doesn't work that way. There are, however, some exceptions to that rule, for example, for performance-based compensation. And without getting into all of the details and the nitty-gritty, it's helpful to be mindful that if you've got a performance-based compensation arrangement, there's a little bit more wiggle room in terms of when the initial deferral election can be made. And you're allowed to actually make it in the year that the compensation relates to, as long as at the time you make the election, the actual level of performance is not known, and it has to be made within a window period at the start of the performance period. So, I think it's some fixed amount of time. And you basically... The idea to take away that I want people to be aware of and take away is, you've got some additional wiggle room, but there are limitations.

And so, you have to go and talk to advisors about what the flexibility you have is, because you can easily get into trouble if you're not mindful of this. You can't just carte blanche say, "We want to put this in place. John didn't think about this in 2026, and now we just want to make the election, sign a piece of paper." It's not so simple as that. Similarly, we were talking before about some of the exceptions to 409A. It's also important to be mindful that just because you're exempt or you're under an exception, like let's say you've got short-term deferral, so you have an amount that is not deemed to be deferred compensation because it fits within that short-term deferral exception, if you want to change that, you want to turn that into deferred compensation, you can't just do it. You still have to run through the permissible deferral election rules. And in this case, with short-term deferral, the IRS takes the position that if you want to now defer it and create and turn it into deferred compensation, you need to generally abide by the subsequent deferral election rules. So, it's not so simple, even with something that's necessarily outside of 409A, to turn it into deferred compensation. There's a lot of potential pitfalls. And so, what are the subsequent deferral election rules? So, at its most basic point, there's really three points. One is you have to make the election at least a year prior to the date that the award would otherwise be paid. The election can't take effect for 12 months. And you have to push out the payment date at least five years from the existing payment date. So, as you can kind of gather from that description, it's really hard to get that done. And typically, a lot of companies will not want to do that

because you've got to take something that's going to be paid out in 2027, and now you can't pay until 2032 at the earliest.

Right. But again, the policy perspective behind this for the IRS is they really want them to reduce the flexibility and the ability for companies and people to have discretion to play with the tax year. And so, if you abide by those rules, then you're allowed to make a deferral. You can't accelerate payments, but you can push it out to a much later date. There are exceptions where you are generally allowed to still allow for payout on a change in control, things of that nature. But as a general matter, that's the framework that you're operating under. And it comes up... The issue comes up a lot where you, let's say you've got a common example I've seen is you have restricted stock units, and we'll get into those in a little bit in the next section on equity comp. You have restricted stock units that are deferred comp that pay, and they're supposed to pay out in 2030, and the company realizes, you know what, we don't have the liquidity. This doesn't make a lot of sense. Maybe they're out of the money. We want to push that off. Well, okay, you can push it off, but you better make that decision before the beginning of the 2029 calendar year, because if you don't, you can't actually do it because you have to, again, make the determination at least a year prior to the payment date, and it can't be effective for a year.

So, there's a lot of limitations and it requires a lot of planning ahead if you want to do a subsequent deferral election. As I was talking a moment ago about restricted stock units, I think it's important to be mindful of how equity compensation and equity-based compensation arrangements play in the 409A framework to begin with. And there's really three types of equity compensation that we'd be dealing with. The first is stock options and stock appreciation rights. The second is restricted stock, which you think of as real equity. And the third is phantom equity, such as restricted stock units. So, stock options, stock appreciation rights, those are appreciation instruments. And essentially, while they would normally be covered by 409A because it's really a contractual right to buy shares, presumably at a discount. And we can have a whole other podcast on how options work and all that, but as a general matter, you're granted an award, you have the ability to exercise it at the fair market value on the date of grant.

And the hope is that when you eventually do exercise it, the actual stock is worth more than the exercise price, and so you get a discounted value. That discount is ordinary income. But the rest of it, you get to buy shares, hopefully at a discount, and then you get to have them. 409A allows... Normally, because options have a lot of flexibility about when you exercise, when you get paid, when the tax implication occurs, they would be non-compliant with 409A. But 409A has an explicit exception for stock options and stock appreciation rights, which economically you would think of as working the same as stock options here. And the idea is that if you comply with particular rules, then we're going to allow those options or SARs to be outside of the coverage of 409A. And so, at a high level, what they require is that the option be on what's called Service Recipient Stock. So that's, in general, that's stock of a...

Common stock of a corporation that they're employed at or a parent. So, employer or above. You can't have an option exempt from 409A at an entity below where you're employed. And it's got to have, in general, no preferences above other classes of stock other than a distribution. So, you can't... It's not supposed to be... They don't want to allow for what could theoretically be debt or priority instruments that can create more flexibility. They don't want to allow for that. So, you have to have service recipient stock. And the option has to have a strike price, an exercise price that is no less than fair market value of the underlying share on the date of grant. And sometimes people will do an internal valuation. A lot of times you'll hear about 409A valuations, which they go out and get a third party. And there's... We can have a whole podcast series on how options and fair market value works in 409A. But generally, there's different frameworks of how fair market value is determined. There's a safe harbor if you go out and get a third-party valuation. But if you meet those requirements, then the option will be... Or the SAR will be exempt from 409A. And that's a pretty helpful option. And another thing I want to just highlight there is the other third point is the option or the SAR cannot allow for a subsequent deferral beyond exercise. You can't say when you exercise, then you can defer the comp another three years or whatever. You can't do that. If you do that, you'll kind of blow up the exemption retroactively to the date of grant. So that's a bad situation. That's stock options and SARs. Restricted stock is the easiest one here because restricted stock is actually property. So, the compensatory transaction for restricted stock is when you get the interest or when it vests. So that's all governed by Section 83 of the Code and is outside of 409A for the most part.

So, if you've got a restricted stock award, all else being equal, you don't have to worry about 409A for the most part. I'll caveat that because there are certain exceptions depending on a particular situation. And the third type is phantom equity. Phantom equity is just a contractual arrangement for payment, which is compensation that's valued by reference to equity or is payable in equity. So restricted stock units is a common one, other phantom awards that are valued by reference and all that. Those can be subject to 409A because they are simply a promise to pay. It's just compensation. And so, if you have those arrangements, you either have to design them to be exempt from 409A, such as under the short-term deferral rule. So, think a restricted stock unit that vests and is then settled, it's paid within 30 days after vesting. Right. So, you're in the short-term deferral exception and you're outside of it. Or it has to be designed to be compliant. So, I'll allow you to vest in your RSU over time and then it's paid on a sale transaction, or it's paid on the third anniversary of vesting or something of that nature. That makes it a little more tricky to work with, but you can design it that way. But it has to be, when you're looking at an arrangement of an RSU, you have to be mindful of 409A and how the arrangement is structured around it.

So that's I think the most important things around equity comp. And so very closely tied to equity comp is the change in control concept under 409A and the transaction-based compensation rule. So, Lori talked a little bit earlier about how a change in control, a 409A change in control, is a permissible payment event under 409A. So, if you have

deferred compensation, you're allowed to pay it out on a change in control. You can think of a change in control as generally an acquisition of more than 50% of the vote or value of a company, an adverse takeover of the board. There's also a change in effective control concept, which is you look at a rolling 12-month period, and you say, have you gotten more than 30%? And there's a rebuttable presumption. And there's also an acquisition of all or substantially all the assets of the company. The threshold is actually lower than that, but if you get over a particular ownership threshold on the assets, you can also trigger a change in control.

So it's important when we look at these arrangements or design them to ensure that if we've got anything that might be deferred compensation payable on a change in control event, that we're very clear that the triggering event here is going to be a 409A-compliant event. A common practice, Lori, tell me if you disagree, I think a common practice that I've used is to have a safety valve on a lot of arrangements where if you're not sure, or maybe it's... Maybe you'd use that, maybe you're piggybacking on the definition from an equity incentive plan and if you're worried about 409A, you'll say, but notwithstanding the foregoing, it'll only be a change in control for this purpose with respect to deferred comp if it's also a 409A change in control in defined term. And so that gives you kind of a backstop that you're not going to potentially have an adverse payment event under 409A. Another trigger is a change in the ownership of a substantial portion of the corporation's assets. And again, you look there to kind of a 12-month period and it's a threshold of the gross fair market value equal to more than 40% of the total gross fair market value of the assets of the corporation would also trigger a change in control. So that's the change in control concept. It's important to be aware that IPOs are not change in controls by definition.

And that's kind of the situation where you might run into problems sometimes, right? If someone's thinking about an IPO exit where you've got a public company, a sell-down is not a change in control. An acquisition of more than 50% by a third party or a group, that's a change in control. But if you have an IPO or you have a subsequent sell-down where you've got multiple owners, that might not trigger. So, people have to be mindful of how that all functions. And tied in closely with that is what's called the transaction-based compensation rule. And the transaction-based compensation rule at a very high level allows you some flexibility when you're dealing with a payout on a change of control, to adjust the timing of payment to account for the transaction is an easy way to think about it.

So oftentimes in a transaction, some amount is paid at the closing, and then subsequent amounts are paid subject to hitting certain thresholds. Maybe there's a holdback or an earnout or an escrow that could be released. And then you would say, "Well, I don't want people to be paid if my shareholders aren't getting paid." And in some cases, maybe that's a risk of forfeiture and it falls under deferred comp, but it may very well not be. So normally you might run into trouble if you say, "Well, I want my guy to be paid, but I also want them to be paid as and when the shareholders are paid."

409A has this exception that says if you've got a transaction-based compensation, which is comp that is valued by reference to the equity or the value of the company, so think like stock options, you can think of phantom equity or a transaction bonus award that's keyed off of the sale value, those might all fit within this, and it's paid on a change of control, you're allowed to adjust your payout timing so that your payments to your service provider are on the same schedule and conditions as the payouts are received by the shareholders.

So, meaning, let's say you're paid out on a deal and then a portion is held in escrow and it's released to the shareholders two years later if certain requirements are met, you can say and you can factor into your payouts for the individual to say they'll get paid on that same schedule subject to the same conditions on the same adjustments. Right? So, you can factor that in there, which is really an economic accommodation. However, the IRS puts a hard stop and says whatever those are, they can't go out more than five years. So as long as... You might see that in deal transactions or documents where it says we're going to be paid as and when, but no later than five years following the closing date, that's the reason for that arrangement. So there's a lot more we could be saying about change of control and transaction-based compensation. There's minute details and it's important to always be mindful of those and to bring in practitioners, but we wanted to give you a flavor for that. And I think very much tied in with those types of arrangements is plan terminations, which is another exemption that allows you to accelerate in some ways where you otherwise might not be able to. So maybe, Lori, do you want to touch on a little bit of what plan termination is and how that gives you additional flexibility in some circumstances?

Lori Basilico (31:22):
Right. Because there's always times when the plan is no longer serving its purpose, it's just too complicated to deal with, no one wants to deal with 409A anymore, so the employer just wants to wind it down and distribute the balances. But Section 409A treats plan termination as a potential acceleration of payment. And as we've been talking about, acceleration is something that is not necessarily permitted under the statute. So instead, the regulations, the 409A regulations, carve out a narrow set of circumstances in which the plan can be terminated and benefits paid out without violating Section 409A. But outside of these circumstances, the money must continue to sit in the plan and be paid according to the original schedule, even if the plan is no longer active.

So, the first and most straightforward permitted termination scenario is in connection with a change of control, the termination of a plan because the company is undergoing a change of control and they want to pay out all this deferred comp. So, under this exception or this ability to accelerate the payments, if a plan is terminated within 30 days before or 12 months after a change of control, one that meets the 409A's definition of change of control, the employer may distribute all of the plan benefits in a lump sum, regardless of what the terms of the plan say. So, one of the key requirements is that all

substantially similar arrangements sponsored by the employer must also be terminated at the same time.

So, you cannot cherry-pick which plans you want to wind down and which to preserve. It's an all-or-nothing proposition for the arrangements of the same type. A second permitted termination event is unrelated to a change of control or financial downturn, sometimes called the discretionary termination option. This is available to any employer at any time, but it comes with strict conditions designed to prevent the termination from functioning as a disguised acceleration. Similar to the change of control termination, the employer must terminate all nonqualified deferred comp plans of the same type, again, no cherry-picking and no payments can be made for at least 12 months after the termination is adopted, and all payments must be paid out within 24 months of the termination date. But most importantly, with this discretionary termination, the employer cannot adopt a new nonqualified deferred compensation plan of the same type for at least three years following the termination. That three-year prohibition is a significant commitment and is designed to ensure that the plan terminations are genuine decisions to exit the deferred compensation space and not a revolving door that allows employers to cash out participants whenever it's convenient. A third scenario covers termination in connection with a corporate dissolution or bankruptcy and basically allows for the termination and the payment to be made. If you're undergoing something that's a bankruptcy or whatever, you would work with bankruptcy counsel in order to make sure that you're not violating 409A. So, it allows, again, for employers to get out of that deferred compensation space if it wants to, but there are certain restrictions that you must adhere to. So, we've generally talked about what is 409A, sort of the different rules around 409A. So, Josh, talk about some common pitfalls that we see generally with respect to 409A?

Josh Gelfand (34:48):
Yeah, definitely. So, I think we talked about and I mentioned the issue with options and that you need to be exempt, it has to be service recipient stock to be exempt. So, I think that a common one that comes up a lot in diligence and it's raised and often asked is a below-market strike price at the time of grant. So, were the options actually granted with an exercise price no less than fair market value on the date of grant? Were they issued from an entity that's not a valid service recipient? Those are very common issues. And understanding if you're doing diligence in a deal, you want to ask the question, were all the options granted with a strike price no less than fair market value? Tell us how you came up with that and show us that contemporaneously with the grants you actually did the analysis to figure that out. That's a big one. Another one that often comes up is impermissible toggling. So, Lori was talking a lot about the types of permissible payments, how they work. Generally speaking, the key here again is IRS does not want discretion. So sometimes you'll see situations where you've got alternative payment events that are not allowed. So, I'm paid in lump sum if I am terminated without cause, but if I quit, then I'm paid out in 10 installment payments. Right? That's not allowed under the rules, things of that nature. Sometimes you also have companies make an

error because they're thinking of phantom equity, which we discussed is subject to 409A. People often think of that and treat it as if it's real equity.

And so, part of that might be that they say, "Well, I've got this phantom unit, I should have a call right on the phantom unit when you terminate employment. I should have discretion to decide to buy you out of your unit when you leave." Well, that's a problem under 409A because we don't allow discretion. So those types of arrangements, building those in, are another common pitfall to be mindful of when you're looking at 409A. So that's really just a flavor of the types of situations and issues that can come up. And again, it can lead to substantial potential exposure depending on the magnitude of the amounts at issue. And even though the lion's share of liability and risk falls to the service provider, there is still withholding and reporting risk and secondary liability for that withholding or failure to withhold for the company. And so, amounts can be real and substantial. So, it's always important to bring in subject matter experts around this area and just have your antennas up about when you hear deferred comp and you see something that seems overly flexible and discretionary, that it can really be a problem and you should be bringing in executive compensation advisors on that. So, the key parting thought is be mindful of discretion under 409A because that's what the rule is designed to prevent.

Lori Basilico (37:39):
All right, well, thanks, Josh. That wraps up today's conversation on Section 409A and nonqualified deferred compensation. If you have any questions or need further assistance, please don't hesitate to reach out to our team at Troutman Pepper Locke.

Josh Gelfand (37:53):
And be sure to check out the additional episodes in our series, *Employee Benefits and Executive Compensation, Preparing for 2027*. We'll be covering other key developments in the employee benefits and executive compensation space. Thanks for listening.

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