Section 409A (Deferred Compensation) 
Issues in Employment Agreements

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What is deferred compensation and how does it arise in Employment Agreements?

- With certain limited exceptions, deferred compensation is a legally binding right to a payment of compensation that arises in one tax year where payment may be made in a later tax year.

- Deferred compensation is defined broadly and includes many items not traditionally considered deferred compensation: for example, severance payments and bonuses may be deferred compensation depending on the terms of the arrangements, and equity incentives may be deferred compensation.

Why does it matter?

- Section 409A imposes strict rules with respect to payment of deferred compensation, and the ability to change the time or form of such payment is extremely limited.

- Any payment of deferred compensation to a “key employee” of a public company due to separation from service must be delayed six months after such separation.

- Failure to comply with Section 409A results in adverse tax consequences to the employee, including a 20% penalty tax and interest from the time that the right to the amount “vested” even if there was no right to payment at that time.
What payments are exempt from Section 409A?

- Any payment that will be made within the “short-term deferral” period will be exempt from 409A. (*This is the most commonly used exception to 409A.*)

- Payments from tax-qualified plans (such as 401(k) plans).

- Welfare benefits

- Incentive stock options, as well as nonstatutory options and stock appreciation rights that meet certain requirement

- Certain severance benefits

**SEVERANCE PAYMENTS**

*Severance that is exempt from 409A:* The short term deferral rule and the “2 times/2 year” rule are the most common exceptions for severance pay.

**The Short Term Deferral Rule**

- Provides an exemption for any payment made no later than 2 and 1/2 months after the end of the later of the employee’s or employer’s tax year in which the right to the deferred compensation is no longer subject to a substantial risk of forfeiture.

- *Keep in mind* that “substantial risk of forfeiture” has a narrower definition than in the past (for example, a non-competition provision does not create a substantial risk of forfeiture, and payments to be made upon certain “good reason” terminations may be deemed not subject to forfeiture, as discussed below).

- It is not required that the agreement provide that payment will be made within the 2 and 1/2 month period in order for a payment made within such period to qualify as a short term deferral. *But the safer course is to include such a provision.* If there is such a provision, the payment may still qualify as a short term deferral if made late under certain circumstances (e.g., it was administratively impracticable to make the payment). Also, if a date is specified and payment is made after that date but within the same calendar year, it might not be exempt from 409A under the short term deferral rule but the payment (provided it is not to a key employee of a public company upon separation from service) will be in compliance with 409A because it will be treated as having been made on a “specified date” (as discussed below).
The “2 Times/2 Year” Rule

- Provides that severance pay that is payable only upon involuntary termination (or pursuant to a “window program”) is exempt if:
  
  (i) the amount paid is not more than the lesser of 2x the service provider’s annual compensation or 2x the IRS limit on compensation for tax-qualified plans (which for 2012 is $250,000, resulting in a limit of $500,000); and
  
  (ii) it is paid within 2 years of termination.

- If severance that otherwise meets the requirements above is greater than the dollar limit, the amount up to the dollar limit will be exempt from 409A (and thus could be paid immediately to a key employee upon a separation from service) and only the remainder will be subject to 409A.

INVOLUNTARY TERMINATION

- An amount that is payable only upon involuntary termination will be deemed subject to a substantial risk of forfeiture (or unvested) until such termination; but an amount payable upon voluntary termination is deemed vested (or not subject to a substantial risk of forfeiture) from the execution date of the agreement for such payment.

- The “2 times/2 year” rule applies only with respect to severance payable upon involuntary termination (or pursuant to a “window program”).

- If an amount is payable upon voluntary termination of employment, the short term deferral rule will generally not apply because the right to payment is vested from the start (and thus the short term deferral period begins running from the execution date of the agreement and not from the date of termination of employment).

- Whether termination for “good reason” is deemed involuntary termination is a facts and circumstances test; “good reason” factors that support involuntary termination include a material negative change in the employee’s situation, such as change in duties or authority, reduction in pay, or change in geographic location.

- There is also a safe harbor definition of “good reason” which requires the following:
  
  ✓ the “good reason” may be a material reduction in compensation, authority or duties, a material change in geographic location, or a material breach of an employment agreement

  ✓ the employee must separate from service within 2 years following the occurrence of the good reason event

  ✓ the employee must give notice of good reason within 90 days of its initial existence and the company must have at least 30 days to cure
✓ payment for good reason termination must be equivalent to payment for involuntary termination

SEVERANCE PAY SUBJECT TO 409A

If severance pay is subject to 409A:

• the payment cannot be accelerated (for example, payments to be made over a two year period cannot be paid in a lump sum)

• payment must be made only upon a specified date or upon a “permissible payment event” (as described below)

• for public companies, any payment of deferred compensation that is to be made to a “key employee” upon separation of service must be delayed for six months following separation from service

Payment upon a specified date

A payment is treated as made upon a specified date if the payment is made:

✓ no earlier than 30 days before such date, or

✓ as of such date or a later date in the same taxable year of the employee, or, if later, by the 15th day of the third month following the specified payment date;

✓ provided that in either case above, the employee is not permitted to designate, either directly or indirectly, the taxable year of the payment

Permissible payment events include:

✓ the employee’s “separation from service” (as defined by 409A and as discussed below)

✓ Change in Control of the employer (as defined by 409A)

✓ an “unforeseeable emergency” of the employee (as defined by 409A)

✓ the employee’s “disability” (as defined by 409A) or death

Separation from Service

• Whether termination of employment will be deemed a “separation from service” for purposes of 409A is a facts and circumstances test.

  ➢ A separation from service will be presumed to have occurred where the employer and employee reasonably anticipate either that: (i) no future services (whether as an employee or a consultant) will be performed by the employee; or (ii) the level of services to be performed will decease to
no more than 20% of the average level of services performed over the preceding 3 year period.

- If the level of services to be performed is expected to be 50% or more of the average level of services previously performed, it will be presumed that a separation from service has not occurred.

- No presumption is made with respect to situations where services are expected to continue at a level between 20% and 50%, but an employment agreement can designate a level within these amounts as constituting a separation from service.

  - Leave of absence of less than 6 months, or more than 6 months if the right to reemployment is guaranteed by law or by contract, is not a separation from service.

**Payments upon Separation from Service to “Key Employees” of Public Companies**

- Any payment to a “key employee” of a public company due to separation from service must be delayed 6 months following separation from service.

- This six-month delay provision must be written into the agreement; it is not sufficient to simply delay the payment.

- A public company is any company whose stock is traded on an established securities market (which may be a foreign market).

- “Key employee” is (i) an officer with annual compensation in excess of an indexed amount which for 2012 is $165,000, (ii) a 5% owner, or (iii) a 1% owner with annual compensation in excess of $150,000.

**Releases**

- A requirement that an employee sign a release in order to receive a benefit does not create a substantial risk of forfeiture; this means that payments that are otherwise vested but subject to signing of a release should not be treated as unvested.

- Severance can be conditioned upon the receipt of a release — that is, the severance will not be paid unless the release is provided — but the timing of the payment cannot be based upon when the employee provides the release.

- Care should be taken when drafting provisions for releases to be sure that the timing for providing the release fits within the 409A permissible payment provisions.
EQUITY COMPENSATION AND OTHER BENEFITS

Equity Compensation

- Incentive stock options (“ISOs”) are exempt from 409A; note, however, that an ISO that ceases to qualify as an ISO (for example, if modified) will be subject to 409A.

- Nonstatutory options (“NSOs”) must meet certain requirements in order to be exempt from 409A, including the following:
  - The exercise price of the NSO must be at least equal to “fair market value” of the stock as of the date of option grant; the 409A regulations provide rules for determining fair market value; and
  - The NSO must be for “service recipient stock,” which means generally, common stock of the company for whom the services are provided, or of a parent corporation.

- Stock appreciation rights (whether settled in cash or stock) that meet the above requirements (issued at fair market value, for service recipient stock) are also exempt.

- Restricted stock grants are generally exempt from 409A.

- Other types of equity compensation may be exempt from 409A under the short term deferral rule if payment is made when the right vests. If the compensation is not exempt, payment must be in compliance with 409A.

Other Benefits

There is an exemption from 409A for certain other benefits including reimbursements for expenses (not otherwise excluded from income), in-kind benefits (such as outplacement counseling, use of a company car, relocation costs) and payments which do not exceed the 402(g) amount (which for 2012 is $17,000), provided that the period during which such expenses are incurred or benefits provided does not exceed the second taxable year of the employee following the year of separation from service (and reimbursement for expenses is paid by the end of the third year following the year of such separation from service).

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