

# WHAT YOU NEED TO KNOW ABOUT IRC SECTION 409A BUT WERE TO AFRAID TO ASK

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## I. IRC Section 409A

- a. Who:
- b. What:
- c. When:
- d. Where:
- e. Why:

## II. When is there a “deferral of compensation”?

## III. Service Providers and Service Recipients.

- a. Service Providers: athletes, creative, artists, above & below the line, professionals
  - i. Exception: Multiple Service Recipient.
  - ii. Partners and Partnerships like corporate stock
  - iii. Section 409A applicable to Cash Basis Method of accounting only, not accrual basis like many C Corps
- b. Service Recipients: production companies, sports teams, record labels
- c. One Person Arrangements:

## IV. Which arrangements covered by 409A?

- a. Top-Hat Plans
- b. Annual Bonus Plans (deferred)
- c. Options and SARs
- d. Phantom Stock and many restricted stock plans
- e. SERPs, excess benefits plans
- f. Some severance agreements
- g. Post termination health , welfare benefits and job perks
- h. Tax gross-up arrangements, like Golden Parachutes

- i. Signing bonus deferred beyond the vesting year, some deferred contingencies
- V. Which arrangements expressly excepted from 409A?
  - a. Tax-qualified retirement plans, 401(k)s, rank and file benefits, union retirement plans with contributions from multiple employers
  - b. Many employee based health plans
  - c. Bona fide vacation, sick leave, compensatory time
  - d. Death benefit, disability and tuition reimbursement plans
  - e. ISOs and employee stock purchase plans
  - f. When IRC Section 83 applies, certain restricted stock & restricted property grants
  - g. Employer based stock options and certain SARs over common stock
  - h. \*\*\*\*\*Subsequent modifications may eliminate an exception\*\*\*\*\*
- VI. Short Term Deferral
  - a. Substantial Risk of Forfeiture
  - b. Prompt Payment
  - c. Deferred Payments
- VII. Section 409A Compliance
  - a. Material terms in writing by the end of the tax year compensation vests
  - b. Timely Election to defer or defer again
  - c. Payment on fixed schedule or certain permissible events, specified at deferral
  - d. Generally no acceleration of payments
  - e. Some “funding” arrangements abusive and prohibited
- VIII. Timing of Deferral Elections
  - a. Applies to elections by service provider and service recipient
  - b. Initial Deferral Elections
  - c. Subsequent Deferral Elections
- IX. Distribution Dates
  - a. Permissible
    - i. Specified date or fixed schedule
    - ii. Separation from service
    - iii. Change in control of service recipient corporation
    - iv. Death of service provider
    - v. Disability of service provider
    - vi. Unforeseeable Emergency
    - vii. Alternative specified dates or payment schedules on permissible event
  - b. Treated as made upon designated payment date or event when:
    - i. Short delay
    - ii. Short acceleration
    - iii. Calculation impracticable
    - iv. Payment would jeopardize service recipient
    - v. Disputed payments and refusals to pay
- X. More detail of permissible events
  - a. Specified time or fixed schedule:
    - i. Objectively determinable amounts paid at date(s) “nondiscretionary and objectively determinable” at time of deferral
    - ii. Vesting Events
    - iii. Objective limitations on Amounts

- iv. Payment Schedule Determined by Timing of Payments Received by Recipient
    - b. Substitutions
  - XI. Exceptions on prohibiting acceleration of payments
    - a. General Rule: no bad Enron style haircut and no prior pledges or collaborations
    - b. Acceleration of vesting permissible, as long as payment not accelerated
    - c. Accelerated distributions permitted:
      - i. Termination of all deferred compensation of employer & affiliates, with payment between 12 and 24 months of termination and three years before establishing new plan
      - ii. Change in control or dissolution in bankruptcy of service recipient
      - iii. Liquidation of service provider's total interest in plan and interest is small
      - iv. Distributions to pay taxes upon a Section 409A violation or other taxes due prior to distribution
  - XII. Violations of Section 409A
    - a. Design or operational
    - b. Consequences: immediately includable in taxable income even though payments years ahead
    - c. 20% penalty tax added for service provider
    - d. Service provider premium interest
    - e. Service providers subject to state income tax, for example in California: additional 20% state income tax resulting in marginal tax rate almost 80%
    - f. Service recipient withholding and reporting requirements
  - XIII. Sports and Entertainment Examples
    - a. Multiple Service Recipient Exception
    - b. Easy Sign-on Bonuses for Sport Teams Multiyear Contracts, Fixed Payments
    - c. Short Term Deferrals based on film success or football player continuing w/ team
    - d. Film Production as a complex arrangement
    - e. Back-End and other Contingencies
    - f. Royalties
    - g. Talent Advances, Signing, Post-Contractual or Collateralizations