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Section 409A Issues in Employment Contracts

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When drafting or negotiating an employment contract, that pained look on an employment lawyer's face may be due to overwork or indigestion, but there's also a high probability that it's due to Section 409A of the Internal Revenue Code of 1986, as amended (Section 409A). Section 409A sets forth complex rules that apply to nonqualified deferred compensation arrangements. Because "nonqualified deferred compensation" is defined very broadly by the Internal Revenue Service (IRS), Section 409A has a significant impact on most employment contracts.

This column is intended to provide a high level overview of Section 409A issues that arise in employment contracts so that an in-house or outside employment lawyer who is not a Section 409A specialist can spot Section 409A issues and feel more comfortable negotiating Section 409A provisions. Consistent with this intent, this column necessarily skirts, and sometimes completely ignores, many complex rules and exceptions that are critical to a thorough understanding of Section 409A issues in employment contracts. An executive compensation attorney should be consulted at all times with regard to Section 409A compliance.

Overview of Section 409A

Section 409A applies to "nonqualified deferred compensation plans." Generally, a nonqualified deferred compensation plan is any plan,

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agreement, or arrangement between a "service recipient" (herein referred to as an "employer") and a "service provider" (herein referred to as an "employee") that provides for deferred compensation.[1] "Deferred compensation" is provided under a plan if the plan gives the employee a legally binding right to receive compensation that may be paid in a future year.[2] Whether a "legally binding right" exists is something of a tricky issue. Basically, a legally binding right exists if the employee has a contractual or statutory right to receive compensation that may be paid in a future year.[3] However, according to the IRS, a legally binding right is not negated if the payment of the compensation is contingent on the occurrence of a future event or is subject to a vesting schedule.[4]

The result of the foregoing is that Section 409A potentially applies to many arrangements that usually are not considered to be "nonqualified deferred compensation plans," such as equity arrangements and severance pay. Thankfully, however, many arrangements providing nonqualified deferred compensation are exempt from Section 409A. Among the exempt arrangements are qualified stock options,[5] restricted stock,[6] qualified retirement plans[7] (*e.g.*, 401(k) plans), and many welfare benefit arrangements.[8] As discussed below, nonqualified stock options and severance pay also are exempt, provided certain conditions are met.

In addition, any arrangement that fits within the so-called "short-term deferral rule" is exempt from Section 409A. The short-term deferral rule is probably the most important, and widely used, exemption under Section 409A. Basically, under the short-term deferral rule, assuming the employer and employee are both calendar year taxpayers (this assumption will be in place for the remainder of this column), an arrangement is exempt from Section 409A if the compensation is paid by March 15th of the year following the year in which the compensation vests.[9] Compensation "vests" under Section 409A when it is no longer subject to a substantial risk of forfeiture.[10]

If an arrangement is not exempt from Section 409A, then it must comply with Section 409A. One requirement set forth under Section 409A is that the arrangement must specify the "payment event," that is, the event upon which the payment of the nonqualified deferred compensation will commence. There are only six permitted payment events under Section 409A:

(1) Separation from service (sometimes referred to herein as a "termination of employment");

(2) A specified date (*e.g.*, an actual date, such as July 1st, 20xx, that must be specified in the arrangement);

(3) Change in control;

(4) Death;

(5) Disability; and

(6) Unforeseeable hardship.[11]

Except for death, each of these payment events has its own unique definition under Section 409A. With limited exception, Section 409A does not permit payments later or earlier than the specified payment event.[12] Another Section 409A requirement (discussed below) is that certain high level employees at public companies must wait six months to receive nonqualified deferred compensation which is paid upon the employee's separation from service.[13] For employment contracts, these are among the most important Section 409A requirements, although other requirements are discussed below.

If an arrangement fails to comply with Section 409A in form or in operation, it will have an adverse tax effect on the employee. Specifically, compensation that is deferred under a non-exempt and non-compliant arrangement, to the extent vested, will be subject to (i) current income taxation, (ii) a 20 percent additional tax, and (iii) interest equal to the underpayment rate plus one percent measured from the time of the deferral.[14] A Section 409A failure will subject an employer only to reporting and withholding obligations.[15] Because the consequences of a Section 409A failure are more severe for the employee than for the employer, it is often the case that the employee's legal counsel will be more persnickety with regard to Section 409A issues in employment contracts than employer's counsel.

Section 409A Issues in Employment Contracts

Any time an employment contract provides for compensation that may be paid in a future year, Section 409A must be considered. When considering Section 409A, counsel should utilize a three-step analytical process. The first step is to determine whether the compensation is exempt from Section 409A. If it is not exempt, the second step is to determine whether the compensation complies with Section 409A. If it is non-compliant, the third and final step is to consider how to structure the payment in a manner that complies with Section 409A. It is important to note that Section 409A does not apply to cash compensation solely. It potentially applies to anything that is taxable as compensation, including equity, taxable reimbursements, and in-kind benefits.

Annual Bonuses

Annual bonuses paid in lump sum usually are exempt from Section 409A. For example, an annual bonus that is paid purely at the discretion of the employer is exempt from Section 409A for two reasons. First, such a bonus does not provide the employee with a "legally binding right" to receive the bonus and, therefore, is not nonqualified deferred compensation. Second, the bonus "vests" on the date of payment and, therefore, is exempt under the short-term deferral rule. For similar reasons, an annual bonus conditioned on the employee being employed by the employer on the date of payment also is exempt from Section 409A. An annual bonus that vests during the year for which the bonus is earned also is exempt under the short-term deferral rule if the bonus is paid on or before March 15th of the following year. To ensure compliance with the short-term deferral rule and to take advantage of certain other Section 409A rules permitting late payments, the employment contract should state specifically that March 15th of the following year is the payment deadline for the annual bonus.

If an annual bonus that vests during the year for which it is earned is not exempt from Section 409A (presumably because the employer is unable to pay the annual bonus by the following March 15th), compliance with Section 409A is achieved easily by specifying in the employment contract the date, or range of dates, in the following year during which the annual bonus will be paid. For example, a compliant employment contract could specify that the annual bonus will be paid on April 1st of the following year or between January 1st and July 1st of the following year.

Equity and Equity-Based Arrangements

Qualified stock options (also referred to as incentive stock options), restricted stock, and employee stock purchase plans are exempt from Section 409A. Nonqualified stock options are exempt, but only if certain conditions are satisfied, the most important of which is that the option's exercise price must never be lower than the fair market value of the underlying stock on the date of grant.[16] Stock appreciation rights also are exempt if certain conditions that are similar to the conditions that apply to nonqualified stock options are satisfied.[17] Phantom stock and other quasi-equity arrangements are subject to Section 409A, unless they are exempt under the short-term deferral rule.

Typically, employment contracts only refer to an employee's right to receive an equity or equity-based award. The actual grant is evidenced by an award agreement that is issued pursuant to a plan document. Employee's counsel will want to review the applicable award agreement and plan document to ensure compliance with Section 409A. Generally, if an employment contract provides for accelerated vesting upon the occurrence of certain events, such as a change in control, it does not present a problem under Section 409A.

Severance Payments

Severance or bridging payments provided under an employment contract may be exempt from Section 409A under either the short-term deferral rule or the so-called "2x2 exemption," discussed below.

Generally speaking, in order for these exemptions to apply, the severance pay must be payable only upon an involuntary termination of employment (or, as explained below, a voluntary termination for good reason, provided the definition of "good reason" satisfies Section 409A).

For example, if an employment contract provides for severance pay equal to one year's base salary payable in lump sum upon (and only upon) an employee's involuntary termination of employment, the severance pay would be exempt under the short-term deferral rule. The reason is that the severance pay vests upon the employee's involuntary termination of employment and the payment would be made by March 15th of the following year. Another example would be if an employment contract provides for severance pay equal to one year's base salary payable in 12 equal monthly installments commencing upon (and only upon) an employee's involuntary termination of employment, all payments made on or prior to March 15th of the following year would be exempt under the short-term deferral rule. It is important to note that, under a quirky Section 409A rule, if the 12-month installment period in the prior example ends after March 15th of the following year, payments made on or prior to March 15th of the following year would be exempt only if the employment contract specifically provides that each installment of severance pay is treated as a separate payment.[18]

For the 2x2 exemption to apply, all of the following requirements must be satisfied:

- The severance pay must be payable only upon an involuntary termination of employment (or, as explained below, a voluntary termination for good reason, provided the definition of "good reason" satisfies Section 409A);

- The severance pay does not exceed two times the lesser of (a) the sum of the employee's annualized compensation based on the annual rate of pay for the year preceding the year of termination, or (b) the Section 401(a)(17) limit for the year in which the termination occurs (in 2015, two times the 401(a)(17) limit is $530,000); and

- The employment contract provides that the severance pay must be paid no later than the last day of the second taxable year of the employee following the year of termination.[19]

As indicated above, the short-term deferral exemption and the 2x2 exemption are predicated on the employment contract providing that severance pay will be paid only upon an involuntary termination of employment. Under a Section 409A safe harbor, an employee's voluntary termination for good reason is treated as being an involuntary termination of employment if all of the following requirements are satisfied and set forth in the employment contract:

- The voluntary termination must occur during a predetermined limited period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the consent of the employee:

  (1) A material diminution in the employee's base compensation;

  (2) A material diminution in the employee's authority, duties, or responsibilities;

  (3) A material diminution in the authority, duties, or responsibilities of the supervisor to whom the employee is required to report, including a requirement that the employee report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar governing body with respect to an entity other than a corporation);

  (4) A material diminution in the budget over which the employee retains authority;

  (5) A material change in the geographic location at which the employee must perform the services; or

  (6) Any other action or inaction that constitutes a material breach by the employer of the agreement under which the employee provides services.

- The amount, time, and form of payment upon the voluntary termination must be substantially identical to the amount, time, and form of payment payable due to an actual involuntary termination, to the extent such a right exists; and

- The employee must be required to provide notice to the employer of the existence of the condition constituting good reason within a period not to exceed 90 days of the initial existence of the condition, upon the notice of which the employer must be provided a period of at least 30 days during which it may remedy the condition and not be required to pay the amount.[20]

Thus, if an employment contract provides for severance pay commencing only upon involuntary termination or voluntary termination for good reason as defined above, the severance pay may be exempt under the short-term deferral rule and/or the 2x2 exemption. However, if the contract's definition of good reason deviates in any way from the above definition (other than if the contract lists less than all six of the good reason conditions), then the severance pay often is treated by the parties who are negotiating the employment contract as not being exempt from Section 409A.

The result of providing nonexempt severance pay is (i) severance pay installments must be paid on specified dates (for this purpose, specifying that the payments will be made on normal payroll dates should suffice), (ii) the release requirements set forth below must be satisfied, and (iii) severance payments must be delayed for at least six months following separation from service if the employee is a top level executive, as described below.

Releases

If the receipt of severance pay that is not exempt from Section 409A is conditioned upon the employee signing a general release or waiver of claims, the employee effectively can control when the severance pay will be paid by delaying the signing of the release. This, according to the IRS, makes the severance pay noncompliant with Section 409A.[21]

There are two solutions to this problem that have been approved by the IRS. The first is that the employment contract may provide that the severance pay will be paid (or payment will commence) on the 60th or 90th day following the employee's separation from service, provided that the release has been executed, and the applicable revocation period has expired, prior to the 60th or 90th day, as applicable.[22] The second is that the employment contract may provide that the severance pay will be paid (or payment will commence) at any time within 90 days following the employee's separation from service so long as (i) the release has been executed and the applicable revocation has expired, and (ii) if the 90-day period spans two calendar years, the payment will be paid (or payment will commence) in the second calendar year.[23]

Six-Month Delay

If an employee receives nonexempt severance pay under his or her employment contract and he or she is a "specified employee" under Section 409A, the payment of the severance pay must be delayed for at least six months from the date of the employee's separation from service.[24] Generally, a specified employee is any of the top 50 most highly paid officers at a public company.[25] This "six-month delay rule" applies not only to severance pay, but also to any nonqualified deferred compensation that is paid upon the employee's separation from service. To deal with the six-month delay rule, employment contracts generally provide that payments that would have been paid to the employee during the first six months following his or her separation from service will be withheld and paid on the first scheduled pay date following the sixth month anniversary of the termination date. However, the employment contract also may provide that the six-month delay no longer applies if the employee dies within such six-month period.[26]

Taxable Reimbursements

Nontaxable reimbursements, such as reimbursements for business expenses, are not subject to Section 409A. Taxable reimbursements (*e.g.*, for country club or gym memberships or tax preparation assistance) are subject to Section 409A. In order to comply with Section 409A, an employment contract that provides for taxable reimbursements and/or taxable in-kind benefits (*e.g.*, the use of a parking space) must provide:

- An objectively determinable nondiscretionary definition of the expenses eligible for reimbursement or of the in-kind benefits to be provided;
- For the reimbursement of expenses incurred or for the provision of the in-kind benefits during an objectively and specifically prescribed period (which could be the term of the employment contract);
- That the amount eligible for reimbursement, or in-kind benefits provided, in one calendar year may not affect the amount eligible for reimbursement, or in-kind benefits to be provided, in any other year;
- That any reimbursement must be made on or before the last day of the calendar year following the calendar year in which the expense was incurred; and
- That the right to reimbursement or in-kind benefits is not subject to liquidation or exchange for another benefit.[27]

Health Coverage

The vast majority of employer-sponsored health plans are exempt from Section 409A. However, discriminatory self-insured health plans present special issues. Generally, discrimination under a self-insured health plan occurs if a "highly compensated individual" is treated more favorably under the plan than any nonhighly compensated individual.[28] For example, if an employment contract provides a highly compensated individual with extra COBRA coverage (*e.g.*, COBRA coverage of 24 months instead of the typical 18 months) or subsidized COBRA coverage, it likely would cause the underlying health plan to be discriminatory unless these benefits also are provided to nonhighly compensated individuals. Depending on how the self-insured health plan discriminates, all or a portion of the benefits provided to the highly compensated individual under the plan become taxable to the highly compensated individual. To date, the IRS generally has not enforced these discrimination rules, but a prudent employer would do well to structure their employment contracts so as not to provide discriminatory health coverage. With regard to Section 409A, discriminatory post-employment health coverage does not violate Section 409A if the period of such coverage is limited to the employee's applicable COBRA period (typically 18 months).[29]

Post-Employment Services and Separation from Service

An employment contract may require an employee to provide, or be available to provide, post-employment services for a period of time, either as a part-time employee or independent contractor. A provision like this raises an issue as to whether a "separation from service" has actually occurred. This is important because the payment event for many forms of nonqualified deferred compensation, including severance pay, is separation from service. If a separation from service occurs, but payment is not made, or if payment is made when a separation from service has not occurred, a violation of Section 409A may result. Generally, with limited exceptions, a separation of service occurs under Section 409A if, at the time of the separation, the employer and the employee both reasonably expect that the employee will perform either (i) no services for the employer in the future, or (ii) services in the future at a rate of no more than 20 percent of the services he or she performed for the employer over the prior three years.[30] A provision of an employment contract providing for post-employment services should be drafted with these rules in mind.

Conclusion

This column discusses many of the 409A issues that arise in employment contracts. Hopefully, it is a bit of antacid for 409A indigestion. Because of its breadth, Section 409A should be considered in connection with most compensation-related provisions of an employment contract. As compliance with Section 409A can be complex and, at times, counterintuitive, an executive compensation specialist should be consulted with regard to issues that may arise.

Notes

1. Treas. Reg. § 1.409A-1(a)(1).
2. Treas. Reg. § 1.409A-1(b)(1).
3. T.D. 9321, Section III.B.
4. *Id.*
5. Treas. Reg. § 1.409A-1(b)(5)(ii).
6. Treas. Reg. § 1.409A-1(b)(6).

7. Treas. Reg. § 1.409A-1(a)(2).

8. Treas. Reg. § 1.409A-1(a)(5).

9. Treas. Reg. § 1.409A-1(b)(4).

10. Treas. Reg. § 1.409A-1(d).

11. Treas. Reg. § 1.409A-3(a).

12. Treas. Reg. § 1.409A-3(b).

13. Treas. Reg. § 1.409A-3(i)(2)(i).

14. 26 U.S.C. § 409A(a)(1).

15. IRS Notice 2008-115; *See also* Prop. Treas. Reg. § 1.409A-4.

16. Treas. Reg. § 1.409A-1(b)(5)(i)(A).

17. Treas. Reg. § 1.409A-1(b)(5)(i)(B).

18. Treas. Reg. § 1.409A-2(b)(2)(iii).

19. Treas. Reg. § 1.409A-1(a)(9)(iii).

20. Treas. Reg. § 1.409A-1(n)(2).

21. IRS Notice 2010-6, § VI.B.I.

22. IRS Notice 2010-6, § VI.B.Z., as modified by IRS Notice 2010-80.

23. *Id.*

24. Treas. Reg. § 1.409A-3(i)(2)(i).

25. Treas. Reg. § 1.409A-1(i)(1).

26. Treas. Reg. § 1.409A-3(i)(2)(i).

27. Treas. Reg. § 1.409A-3(i)(1)(iv).

28. 26 U.S.C. § 105(h)(2).

29. Treas. Reg. § 1.409A-1(b)(9)(v)(B).

30. Treas. Reg. § 1.409A-1(h)(1)(ii).