Code Section 409A:

Prevent Angry Executives and IRS Windfalls

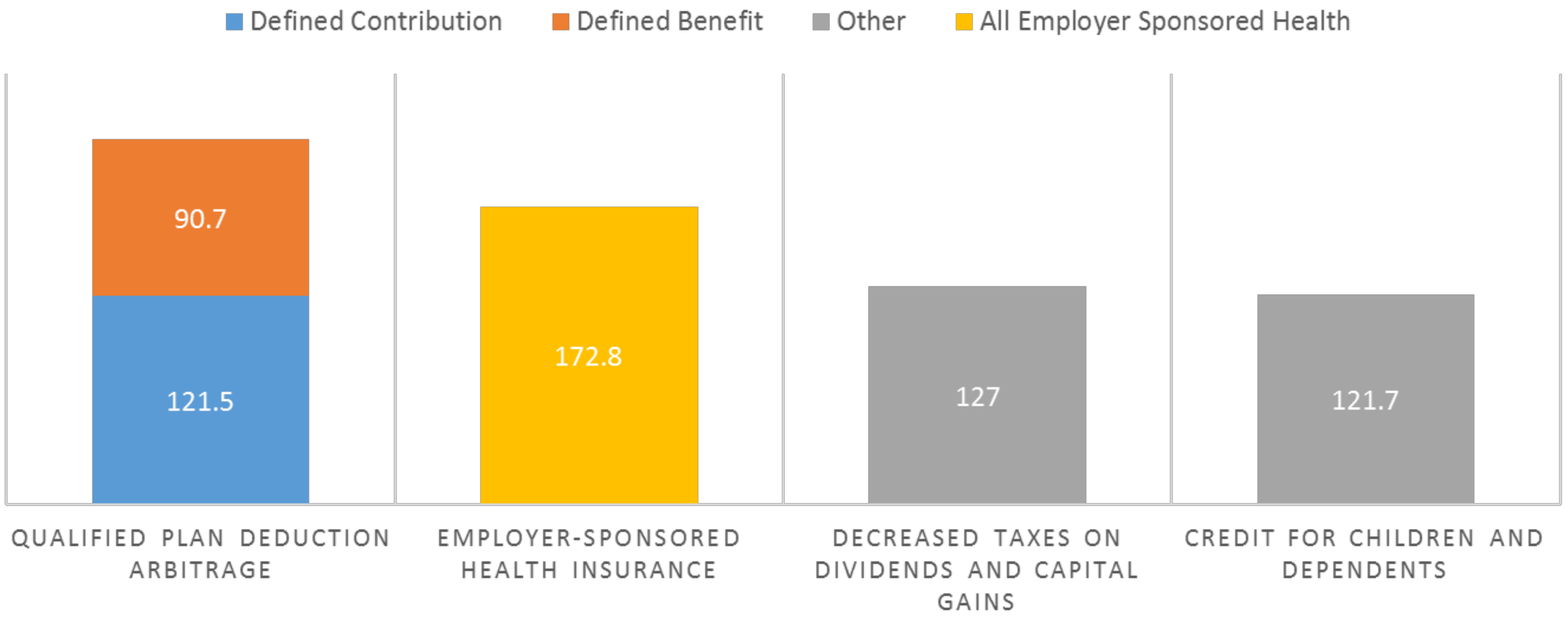
ACC Association of Corporate Counsel

Presented By:
Corey Slagle
Ogletree Deakins

What is 409A?

- As tax policy, incentivizing retirement savings is expensive for Treasury / IRS.
- Beginning in the 60s and 70s, the IRS began limiting the amounts that could be deferred under "qualified" plans.

Top 5 Tax Expenditures for 2019
(in Billions)



What is 409A?

- Qualified retirement plans are expensive for the government.
- Contributions and comp. limited for top executives for policy and expenditure reasons.

Contribution limit for defined contribution plan under Code § 415(c)	**$56,000** (*$1,000 increase*)
Benefit limitation for defined benefit plan under Code § 415(b)	**$225,000** (*$5,000 increase*)
Elective deferral limit under Code § 402(g)	**$19,000** (*$500 increase*)
Age 50 catch-up contribution limit under Code § 414(v)	**$6,000** (*no increase*)
Age 50 catch-up contribution limit for SIMPLE plan	**$3,000** (*no increase*)
Contribution limit for a Code § 457(b) eligible deferred compensation plan	**$19,000** (*$500 increase*)
Annual compensation limit under Code § 401(a)(17)	**$280,000** (*$5,000 increase*)
HCE compensation definition dollar threshold	**$125,000** (*$5,000 increase*)
Dollar threshold limitation for key employee determination in top-heavy	**$180,000** (*$5,000 increase*)
Contribution limit for a SIMPLE retirement plan	**$13,000** (*$500 increase*)
Participant compensation eligibility amount under Code § 408(k)(2)(C) for simplified employee pension (SEP) employer contributions	**$600** (*no increase*)

What is 409A?

- Beginning in 1960s and 70s, Employers began establishing special executive plans to assist with executive savings, retention, employer cash flow, and employee tax rates.
- Typical structures – equity compensation, qualified plan DC and DB offset plans, and long-term bonus structures.
- For historical, obtuse tax reasons, all compensation must be paid out of the general assets of employer.
- No segregated trust funds or set-aside amounts.
- All promises worthless in bankruptcy. . .

Executive Compensation's Watershed Moment – 12/2/01

What is 409A?

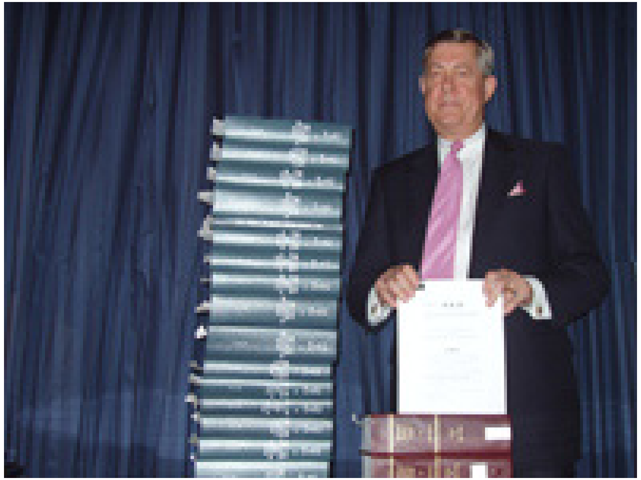
- Enron execs. know bankruptcy is coming and know non-qualified plans are worthless.
- Negotiate "haircut" exits where they take 90% of balances.
- ~ 30 Execs move about $32 million out of plans.
- Employee pensions, 401(k) accounts invested in Enron stock, and creditors take a huge bath.

What is 409A?

- 409A passes with relatively minor legislative mandate – fix time and form of payment of deferred comp. to prevent a run on the bank pre-bankruptcy.
- IRS interprets this mandate as a regulatory bonanza.

What is 409A?

- 2 pages of statute
- 100 pages of proposed regulations
- 500 pages of final regulations



409A Penalties

409A Penalties

Your “Dollar”	1.00
Less Federal Income Tax at 35%	.35
Remaining “Dollar”	.65

409A Penalties

Your "Dollar"	.65
Less State Income Tax at 6%	.06
Remaining "Dollar"	.59

409A Penalties

	Your "Dollar"	.59
Less	409A Tax at 20%	<u>.20</u>
	Remaining "Dollar"	.39

409A Penalties

	Your "Dollar"	.39
Less	409A Interest Penalty at 8%	.08
	Remaining "Dollar"	.31

409A Penalties

	Your "Dollar"	.31
Less	FICA at 8%	.09
	Remaining "Dollar"	.22

409A Penalties - All That Remains

Yes, but isn't this the employee's problem?

It’s also your problem.

- Employee’s (usually correctly) see failures caused by employers and want to be made whole.
- Reporting and withholding obligation when there is a failure – in egregious cases, IRS can seek recoupment of penalties from employer.

Surely There's a Limited Scope?

- Deferred Compensation = Services provided in one year with payment potentially in a subsequent year.
- Super small, right?

Huge Scope!

- Traditional deferred comp.
- Stock options.
- Restricted stock units.
- Restricted stock (sometimes).
- Profits interests (occasionally).

Huge Scope!

- Employment agreements.
- Separation agreements.
- Retention agreements.
- Reimbursement agreements.
- Perquisite plans.
- Pay for teachers over school years.

Huge Scope!

- Short term bonuses.
- Long term bonuses.
- Commissions.
- Spot bonuses.
- Longevity bonuses.

Huge Scope!

- Change in control agreements.
- Tax gross-up agreements.
- Compensatory deal earn-outs.
- International tax equalization agreements.
- Split dollar life insurance.

Huge Scope!

- Taxable employment expenses.
- Corporate jet use programs.
- Unwritten bonus plans.
- SERPs.
- Phantom stock.

Huge Scope!

- Basically everything “comp-y” other than base salary (but sometimes base salary).

With a Scope So Broad, Surely the Rules are Simple?

This is Easy

$$
\begin{aligned}
B(x''t''\tau''; x't'\tau') &= \frac{1}{C(\epsilon)} \prod_{n=1}^{N-1} \int \frac{d\tilde{x}_n}{C(\epsilon)} \exp\left\{ \frac{-i\epsilon}{\hbar} \sum_{n=1}^{N} \left[\frac{m}{2} \left(\frac{\tilde{x}_n - \tilde{x}_{n-1}}{\epsilon} \right)^2 - V\left(\frac{\tilde{x}_n + \tilde{x}_{n-1}}{2} \right) \right] \right\} \\
&\quad \cdot \frac{1}{C(\epsilon)} \prod_{n=1}^{N-1} \int \frac{dx_n}{C(\epsilon)} \exp\left\{ \frac{i\epsilon}{\hbar} \sum_{n=1}^{N} \left[\frac{m}{2} \left(\frac{x_n - x_{n-1}}{\epsilon} \right)^2 - V\left(\frac{x_n + x_{n-1}}{2} \right) \right] \right\} \\
&= \frac{1}{|C(\epsilon)|^2} \iint \frac{d\tilde{x}_1\, dx_1}{|C(\epsilon)|^2} \iint \frac{d\tilde{x}_2\, dx_2}{|C(\epsilon)|^2} \cdots \iint \frac{d\tilde{x}_{N-1}\, dx_{N-1}}{|C(\epsilon)|^2} \\
&\quad \times \exp\left\{ \frac{i\epsilon}{\hbar} \sum_{n=1}^{N} \left(\frac{m}{2} \left[\left(\frac{x_n - x_{n-1}}{\epsilon} \right)^2 - \left(\frac{\tilde{x}_n - \tilde{x}_{n-1}}{\epsilon} \right)^2 \right] \right. \right. \\
&\quad \left. \left. - \left[V\left(\frac{x_n + x_{n-1}}{2} \right) - V\left(\frac{\tilde{x}_n + \tilde{x}_{n-1}}{2} \right) \right] \right) \right\}. \qquad (23)
\end{aligned}
$$

This is Hard

409A

General 409A Rules

- No accelerations.
- Deferral windows limited.
- Payment triggers limited – death, disability, change in control, fixed time, or unforeseeable emergency.
- Written requirement – Plans must be 100% correct on day one or there is a 409A violation.
- Six Month Delay – Top 50 employees of a public company must wait six months post-termination to receive separation pay.

Examples of 409A Failures – Consulting Agreement

- CFO of private company is due deferred compensation payout of $200k lump-sum on retirement.
- Retires in late November, 2019, but enters into consulting agreement that's initially 25 hrs. per week and tapers down to 10 in March of 2020 after financials are finished.
- Entered into HRIS as "retired" and consultant via a 1099 "independent contractor" arrangement.
- Company pays out in December.


FAIL

Examples of 409A Failures – Consulting Agreement

"Separation from Service" has a 409A definition that's not intuitive:

Post "Termination" Service	Result
< 20%	Presumed Separated
20 – 50%	No Presumption
> 50%	Presumed Not Separated

- 25 hrs. per week = likely not separated = likely 409A violation.
- 409A Fix – Wait until January to make deferred comp. payout.

Examples of 409A Failures – Separation Agreements

- Employee terminated in December and promised lump-sum severance if she signs claims release.
- Separation agreement is silent on when agreement must be signed.


FAIL

Examples of 409A Failures – Separation Agreements

- No fixed time for payment - employee could potentially hold on to agreement in December and defer payment into January.
- Two Easy Fixes –
  - 45 days to consider and return agreement.
  - If consideration period spans two years, payout in second year regardless of when agreement returned.

Examples of 409A Failures – Bonus Plan

- Annual Bonus payout to employees calculated based on CY performance.
- If termination after end of CY, employees still paid out.
- Pay out made when financials completed.


FAIL

Examples of 409A Failures – Bonus Payout

- 409A requires fixed date for payout.
- Even if 2019 payout actually happens in 2020, company could theoretically not complete financials and delay payments until 2021.
- 2 Easy Fixes:
  - Payout in all events no later than end of following year.
  - Employee must be actively employed on payout date.

One HUGE Exception to 409A – Short Term Deferrals

Short-Term Deferrals

- Payout in all cases by March 15th of year following the year in which "substantial risk of forfeiture" lapses.
- If short-term deferral – not subject to 409A which results in added flexibility.
- SROF – usually exists if active employment is required for payout, but can be based on performance criteria being met for payout.
- SROF – involuntary or "good reason" (defined by regs.) termination can result in acceleration.

Short-Term Deferral Example

- Stock units cliff-vest 3 years following grant. 50% are time-based, 50% are based on obtaining net sales of $10 million.
- If Age 55 and 10 years of service, employee can retire and get pro-rata payout of time based immediately and perf. based at end of performance period.

Short-Term Deferral Example

- Short Term Deferral?
- Time-Based. Not for anyone who could conceivably retire in 3 year period because retirement in voluntary termination.
- Performance-Based. Probably, unless net-sales target is super easy to meet.

Short-Term Deferral Example – Why Does Exemption Matter?

- If acrimonious termination, but desire to negotiate a managed settlement –
- No flexibility for time-based payouts. Must be paid if at all on initial payout date.
- Total flexibility for performance-based payouts. Can be accelerated! (But not deferred)