The Section 409A Minefield: Employment Agreements
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Agenda

• Background

• The 409A minefield - employment agreement terms affected

• Specific applications & sample provisions
The Section 409A Minefield: Employment Agreements

Background

What is Section 409A (“409A”)?

• Section of the Tax Code, which became effective January 1, 2005

• Response to Enron – American Jobs Creation Act of 2004

• Requires that “nonqualified deferred compensation” (“NQDC”) either:
  • Satisfy the specified requirements of 409A; or
  • Qualify for an exception to 409A
The Section 409A Minefield: Employment Agreements

**Background**

**To whom does 409A apply?**

- **Service Providers**
  - Employees, directors and independent contractors

- **Service Recipients**
  - Taxable and tax-exempt entities
  - Tax-exempt entities are also subject to Section 457, so 409A typically only affects severance payable to their employees
Background

What is NQDC?

- Basic definition: any compensation in exchange for services that is earned in one taxable year and paid in a later taxable year

- Look at the period over which the compensation is earned and when the employee obtains a legally binding right to the compensation

- Concept includes many items not typically thought of as NQDC, but some may be excluded from 409A by an exception
**Background**

**What compensation is excluded from NQDC?**

- “Qualified” deferred compensation – e.g., 401(k) and 403(b) plans
- “Bona fide” vacation, sick leave, compensatory time and death benefits
- Nontaxable benefits – e.g., certain educational benefits, indemnification
- Payroll year-end straddle period
- Certain annualized compensation arrangements – e.g., teacher salary
Background

Are there any exceptions to 409A?

• Grandfathered amounts
  • Earned and vested before January 1, 2005
  • Not materially modified

• Stock rights exception
  • Stock options with exercise price => FMV at time of grant

• Short-term deferral exception

• Involuntary separation pay exception
The Section 409A Minefield: Employment Agreements

**Background**

**What does the short-term deferral exception require?**

- Generally, the NQDC must be payable no later than March 15th of the calendar year following the calendar year in which the payment is no longer subject to a 409A “substantial risk of forfeiture”

- Exception not available if payment could be made later than deadline

- Limited permissible late payments without losing exception
  - Legally required delay
  - Payment would jeopardize employer’s ability to continue as a going concern
Background

What does the involuntary separation pay exception require?

- 409A “separation from service”
- Only payable in the event of an involuntary separation from service
  - “Good Reason” provisions okay if substantially equivalent to an involuntary termination
- Up to 2x lesser of:
  - Employee’s 409A “annualized compensation”
  - Code Section 401(a)(17) limit - $270,000 for 2017
Background

What does 409A require?

1. Permissible payment times and events
   • specified date (including a specified year)
   • 409A “separation from service”
   • death
   • 409A “disability”
   • 409A “change in ownership,” “change in effective control” or “change in ownership of a substantial portion of the assets”
Background

What does 409A require? (continued)

2. Deadline for specifying/electing time and form of payment of NQDC

3. Prohibition against acceleration of payment of NQDC, with very limited exceptions – e.g., unforeseeable financial emergency, domestic relations order

4. Limited ability to later delay payment of NQDC

5. Must be in writing
Background

What happens if there is a violation of 409A?

- **Employee**
  - Immediate income tax (or upon vesting)
  - 20% penalty tax (on top of usual income tax)
  - Possible interest penalty

- **Employer**
  - Required income tax withholding (but not penalty tax or interest)
  - Required wage reporting also indicating 409A violation
  - Liability to employee?
Background

Can 409A violations be cured?

- IRS correction programs
  - Operational failures
  - Documentary failures

- Tax doctrines

- In some instances, correction may not be possible
Background

Has there been IRS enforcement of 409A?

- Erroneous belief of lack of enforcement
- IRS audit guidelines and audit activity
- Court decisions
- Expectations under Trump administration?
The 409A minefield - employment agreement terms affected

Why is it a minefield?

• Employment agreements typically can cover numerous different items of compensation

• 409A is extremely complex and technical

• 409A is not intuitive, so high probability for error

• There are plan aggregation rules for some purposes, so must look beyond the employment agreement document sometimes
The 409A minefield - employment agreement terms affected

What employment agreement terms may be affected by 409A?

- Annual bonuses
- Long-term bonuses*
- Equity awards*
- Reimbursements
- Severance pay
- Change in control benefits
- Outplacement services
- Offsets
- 409A provision
The 409A minefield - employment agreement terms affected

What things should I watch out for?

• Conflict between (i) the payment terms in employment agreement, and (ii) the payment terms under the applicable compensation arrangement

• 409A substitute payment rule

• Use of “as soon as possible” for payment

• Giving the employee or the employer the discretion to accelerate payment without including the subsequent election requirements

• Toggle issue

• Inconsistent 409A provision
The 409A minefield - employment agreement terms affected

What is the toggle issue?

• Different time and form of payment limited by three types of terminations
  • Retirement – separation from service after meeting age/years of service requirements
  • CIC termination – separation from service in connection with a change in control of the employer
  • Other termination – any other separation from service (*wildcard*)
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Specific applications & sample provisions

Annual Bonus

• Defer to company arrangement

Employee shall be eligible for an annual bonus each year under the company’s annual bonus arrangement covering Employee, payable pursuant to the terms of such arrangement
Specific applications & sample provisions

Annual Bonus  (continued)

• 409A compliant

  *Employee shall be entitled to an annual bonus each year of at least $1,000, payable in the subsequent year*

• 409A short-term deferral exemption

  *Employee shall be entitled to an annual bonus each year of at least $1,000, payable no later than March 15th of the subsequent year*
Specific applications & sample provisions

Reimbursements

• Taxable reimbursements

To the extent any reimbursement provided under this Agreement is includable in Employee’s income:

i. such reimbursements shall be paid to Employee no later than December 31st of the year following the year in which Employee incurs the expense, and

ii. the amount of reimbursable expenses provided in one year shall not increase or decrease the amount of reimbursable expenses to be provided in a subsequent year
Specific applications & sample provisions

Severance pay

• Qualifier for “termination of employment”

*To the extent necessary to comply with or qualify for an exception from Section 409A of the Code, references to Employee’s “termination of employment” and similar terms used in this Agreement will mean Employee’s “separation from service” within the meaning given such term by Section 409A*
Specific applications & sample provisions

Severance pay (continued)

- Defer to company arrangement

In the event of Employee’s termination of employment, Employee shall be entitled to receive payment of severance under the company’s severance plan covering Employee, payable pursuant to the terms of such plan
Specific applications & sample provisions

Severance pay (continued)

• 409A compliant

In the event of Employee’s termination of employment, Employee shall be entitled to receive payment of severance in amount equal to 52 weeks’ of base salary, payable in accordance with the company’s regular payroll practices over such period.
Specific applications & sample provisions

Severance pay (continued)

• 409A compliant (continued)
  • If waiver and release required:

  *If the applicable period following termination of employment during which Employee may execute and revoke a waiver and release crosses over from calendar year into the following calendar year, the payment of severance shall commence no sooner than the first day of the following calendar year*
Specific applications & sample provisions

Severance pay (continued)

- 409A short-term deferral exception
  - Full amount

  In the event of Employee’s termination of employment, Employee shall be entitled to receive payment of severance in amount equal to 52 weeks’ of base salary, payable in a lump sum no later than March 15th of the year following the year in which Employee’s termination of employment occurs.

- Note, no waiver and release issue if exempt
Specific applications & sample provisions

Severance pay (continued)

- 409A short-term deferral exception (continued)
  - Portion payable by March 15th of subsequent year

In the event of Employee’s termination of employment, Employee shall be entitled to receive payment of severance in amount equal to 52 weeks’ of base salary, payable in accordance with the company’s regular payroll practices over such period.

Each payment of severance under this Agreement will be treated as a separate payment for purposes of Section 409A

- Note, no waiver and release issue if exempt
Specific applications & sample provisions

Severance pay (continued)

• 409A involuntary separation pay exemption

_in the event of Employee’s involuntary termination of employment, Employee shall be entitled to receive payment of severance in amount equal to $500,000, payable in accordance with the company’s regular payroll practices over the 12-month period following Employee’s termination of employment._

_each payment of severance under this Agreement will be treated as a separate payment for purposes of Section 409A_
Specific applications & sample provisions

Severance pay (continued)

- 409A involuntary separation pay exemption (continued)
  - 409A “specified employee” qualifier

If Employee is a “specified employee” for purposes of Section 409A of the Code, and the amount of severance exceeds the lesser of two times (a) Employee’s “annualized compensation” for purposes of Section 409A of the Code, and (b) the limit under Section 401(a)(17) of the Code for the year in which the termination of employment occurs, then the excess amount of severance otherwise payable to Employee during the six-month period following Employee’s termination of employment shall be paid without interest in a lump sum on the first day of the seventh month following Employee’s termination of employment.
Specific applications & sample provisions

Change in control benefits

• Single trigger payment

Upon a Change in Control of the company that also qualifies as a “change in ownership,” a “change in the effective control” or a “change in a substantial portion of the assets” of the company for purposes of Section 409A, the Employee shall be entitled to a payment in an amount equal to two times his or her base salary on the date of the Change in Control, payable in substantially equal monthly installments over the 24-month period beginning on the first day of the month following the month in which the Change in Control occurs.
Specific applications & sample provisions

Change in control benefits

- Double trigger

In the event of the termination of Employee’s employment within the 12-month period following a Change in Control of the company, the Employee shall become immediately vested in his or her outstanding long-term bonuses, and if the Change in Control also qualifies as a “change in ownership,” a “change in the effective control” or a “change in a substantial portion of the assets” of the company for purposes of Section 409A, payment of such outstanding long-term bonuses shall be made within 30 days following the date of the termination of Employee’s employment

- Beware of toggle issue
Specific applications & sample provisions

Outplacement services

Following termination of employment, Employee shall be entitled to outplacement services. Such outplacement services shall not be provided beyond December 31st of the second year following the year of Employee’s termination of employment, and any reimbursements to Employee for such services shall be paid no later than December 31st of the third year following the year of Employee’s termination of employment.
Specific applications & sample provisions

Offsets

The company may reduce the amount of any payment otherwise payable to or on behalf of Employee at the time payment is due by the amount of any loan or other obligation of Employee to the company that is then due and payable.

In addition, the company may at any time offset amounts owed by an amount up to $5,000 per year to collect any loan or other obligation of Employee to the company in accordance with the requirements of Section 409A.
Specific applications & sample provisions

409A provision

- Definition of 409A

For purposes of this Agreement, “Section 409A” shall mean Section 409A of the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated and other official guidance issued thereunder.
Specific applications & sample provisions

409A provision

- Intention for 409A exemption or compliance

_The compensation and benefits under this Agreement are intended to qualify for an exemption from or to comply with the requirements of Section 409A, and this Agreement shall be administered and interpreted consistent with such intention._
Specific applications & sample provisions

409A provision

- No employer liability

_Notwithstanding the foregoing, the company makes no representations that the payments and benefits provided under this Agreement qualify for an exemption from or comply with the requirements of Section 409A, and in no event shall the company be liable for all or any portion of any taxes, penalties, interest or other expenses that may be incurred by Employee on account of non-compliance with Section 409A, nor for the reporting by the Company in good faith of any payment made under this Agreement as an amount includible in gross income under Section 409A._
Specific applications & sample provisions

409A provision

• Termination means 409A “separation from service”

To the extent necessary to comply with or qualify for an exception from Section 409A of the Code, references to Employee’s “termination of employment” and similar terms used in this Agreement will mean Employee’s “separation from service” within the meaning given such term by Section 409A
Specific applications & sample provisions

409A provision

• 409A “specified employee” six-month delay

In the event that the Employee is a “specified employee” for purposes of Section 409A at the time of separation from service, any separation pay or other compensation payable hereunder by reason of such separation of service that would otherwise be paid during the six-month period immediately following such separation from service shall instead be paid on the first day of the seventh month following the separation from service to the extent required to comply with Section 409A.
Specific applications & sample provisions

409A provision

- Separate payments for purposes of 409A

*Each payment of severance under this Agreement will be treated as a separate payment for purposes of Section 409A*
Specific applications & sample provisions

409A provision

• Employer discretion to revise agreement to comply with 409A

To the extent that any payment or benefit pursuant to this Agreement would fail to comply with the requirements of Section 409A, the company may, in its sole and absolute discretion and without the consent of Employee, make such modifications to the timing or manner of such payment and/or benefit to the extent it determines necessary or advisable to comply with the requirements of Section 409A; provided, however, that the company shall not be obligated to make any such modifications. Any such modifications made by the company shall, to the maximum extent permitted by Section 409A, preserve the aggregate monetary face value of such payments and/or benefits provided by this Agreement in the absence of such modification; provided, however, that the company shall in no event be obligated to pay any interest or other compensation in respect of any delay of such payments or benefits in order to comply with the requirements of Section 409A.
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