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# **EXECUTIVE COMPENSATION ACADEMY**

**BREAKING DOWN THE MYTHS AND  
MISCONCEPTIONS ABOUT 409A TO ITS BASICS**

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# Presenters



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# **SECTION 409A BACKGROUND**

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# Section 409A Background

- Internal Revenue Code (Code) Section 409A provides specific rules for deferral elections, distributions, and funding mechanisms under nonqualified deferred compensation plans.
- Code Section 409A applies to amounts "deferred" after 2004, and older plans grandfathered if the amount was vested at December 31, 2004 and not "materially modified" after October 4, 2004.
- Individuals in noncompliant plans are subject to tax at the time of vesting plus a 20% penalty tax, plus interest at the underpayment rate plus 1%.
- Employer risk relates to withholding and reporting obligations.



# **“DEFERRED COMPENSATION”**

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# Deferred Compensation

- Deferred compensation results in current taxable income as of the date the income is fully earned and not subject to a substantial risk of forfeiture unless the Section 409A rules are met.
- Deferred compensation is broadly defined under Section 409A as: *Any arrangement under which the service provider has a legally binding right in one year to compensation that will be paid in a later year.*

# Deferred Compensation

- Section 409A applies to the following nonqualified plans:
  - Account balance deferred compensation plans (401(k) wrap plans, elective deferral plans)
  - Defined benefit plans (SERPs)
  - 457(f) plans (for tax-exempt entities)
- Section 409A can also apply to:
  - Severance plans,
  - Employment agreements,
  - Discounted stock options,
  - Restricted stock unit that is paid after vesting, and
  - Annual or long-term incentive plans that pay after vesting

# Deferred Compensation

- Deferred compensation does not include:
  - Amounts paid shortly after vesting (“short-term deferral” rule)
  - Vanilla stock options and SARs
  - Restricted property under Section 83
  - Partnership interests
  - Qualified plans (401(k) plans, qualified pension plans)
  - Certain severance benefits



# Short-Term Deferral Exception

- Amounts that are paid shortly after vesting are not subject to Section 409A
  - If paid in the same tax year as vesting, or
  - Not later than 2½ months after the later of
    - End of the employee's taxable year in which vesting occurs, or
    - End of the employer's taxable year in which vesting occurs
  - Exclusion does not apply if the amount is further deferred
  - Late payment of such an amount is an automatic violation of Section 409A if the plan does not provide a fixed date/year by which payments are to be made

# **WAS A TIMELY DEFERRAL MADE?**

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# Deferral Elections – Initial & Subsequent

- Participant elections as to form/timing of payment
  - **General Rule:** Participant elections generally must be irrevocable and must be made before the calendar year in which the compensation will be earned
    - Includes election as to both the time and form of payment
  - **Subsequent Deferral Election:** May elect to defer compensation after the beginning of the year in which services commence, if election is made 12 months before the scheduled payment date, and election pushes out the receipt of compensation by at least five years (12-month/5-year rule)

# Deferral Elections

- Numerous exceptions:
  - **First-time eligibility in plan (and all plans of the same type):** initial deferral election permitted must be made within 30 days of first eligibility for participation
  - **Fiscal year–based compensation:** Elections for fiscal year–based compensation may be made by the last day of the prior fiscal year
  - **Performance-based compensation:** Elections may be made as late as six months before the end of the performance period for performance-based compensation
  - **Compensation that remains unvested for 12 months:** initial deferral election permitted up to 30 days after an employee attains binding right (but not later than the date that is 12 months before the vesting date)



# PERMITTED PAYMENT EVENTS

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# Permitted Payment Events

- Permitted Section 409A distribution events:
  - Specified date(s)
  - Separation from service
    - Six-month wait for “specified employees” of a public company
  - Death
  - Disability (within the definition of Section 409A)
  - Change in control (within the definition of Section 409A)
  - Unforeseeable financial emergency (within the definition of Section 409A)

# Section 409A Convenience Rules

- In certain situations, a distribution does not have to be made immediately upon the occurrence of a permitted distribution event:
  - A distribution will be timely if made within the same calendar year or, if later, by the 15th day of the third month following the distribution date specified by the plan

# Distributions on a Fixed Date or Fixed Schedule

- Plans may specify the calendar year or years in which the payments will be made, without specifying the date
- Fixed date or schedule may be triggered by an event that is subject to a substantial risk of forfeiture where the date of the event is unknown
  - E.g., payment due on a change of control will be paid in three annual installments beginning in the year following the change of control



# Acceleration of Distributions

- Payment of NQDC subject to Section 409A generally cannot be accelerated
- Exceptions:
  - Payments under a domestic relations order
  - Payments to comply with ethics agreements with the federal government, or ethics laws or conflict-of-interest laws of a federal, state, local, or foreign government
  - Payments necessary to pay FICA taxes when deferred compensation vests
  - Payment upon income inclusion for Section 409A noncompliance
  - Limited cash-outs
  - Other limited exceptions

# Plan Termination Distributions

- A plan may be terminated, and benefits distributed, if:
  - The termination is not proximate to a downturn in the employer's financial health
  - All aggregated plans are similarly terminated
  - Payments upon termination may not be made earlier than 12 months after all necessary steps have been taken for plan termination
  - All amounts must be distributed within 24 months following the plan termination
  - No new plan of the same type may be adopted for three years after the termination
- A plan may be terminated in connection with a Section 409A change in control – but all plans that are required to be aggregated must be terminated
- A plan may be terminated, and benefits distributed, following a corporate dissolution or if permitted by a bankruptcy court under certain conditions

# FUNDING

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# Unfunded

- Deferred compensation arrangements must be unfunded promises to pay amounts in a future tax year
- Rabbi trusts can be used

# COMPLIANCE & ERRORS

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# Operational Compliance Errors

- Common Section 409A compliance errors include:
  - Failure to meet the exemption requirements if intended to be exempt (for example, pricing of stock options)
  - Failure to make deferral or distribution elections in a timely manner
  - Incorrect calculation of plan deferrals and distributions
  - Early payment of an amount payable in a later year (including by not abiding by the six-month deferral rule for specified employees of public companies)
  - Late payment of an amount payable in an earlier year (impermissible deferral)
- The IRS has a correction program that can minimize or even eliminate Section 409A penalties
  - Generally cannot correct beyond two calendar years following the error

# Documentary Compliance

- The deferred compensation arrangement must be in writing
  - The arrangement may be in more than one document
  - The arrangement must set forth requirements regarding:
    - Amount to be paid or formula for calculating payment,
    - Time and form of payment, and
    - Election requirements
      - Both initial and deferral
    - Six-month delay for “specified employees” of a public company

# Penalties for Noncompliance

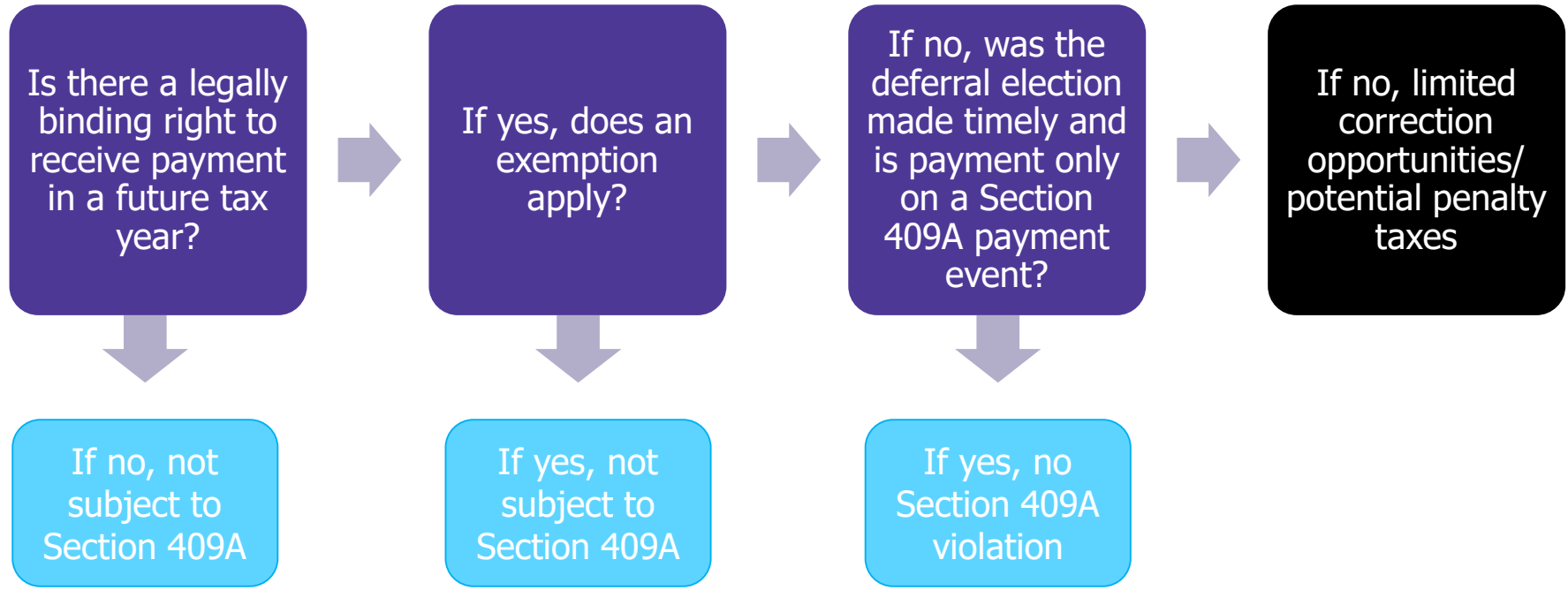
- Failure to comply with Section 409A will result in significant tax penalties for the employee
  - Employer has a reporting obligation
- Immediate taxation of all deferred amounts when there is no longer a substantial risk of forfeiture (not deferred to time of actual distribution)
- In addition to income inclusion, the following apply to the individual:
  - Penalty tax of 20% of amount included in income, and
  - Interest is assessed on the tax underpayments (at underpayment rate plus 1%)
- States may impose penalties as well



# **DETERMINING IF AN ARRANGEMENT IS SUBJECT TO SECTION 409A**

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# Section 409A Basics – Thought Process



# QUESTIONS?

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# Coronavirus COVID-19 Resources

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

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To help keep you on top of developments as they unfold, we also have launched a resource page on our website at [www.morganlewis.com/topics/coronavirus-covid-19](http://www.morganlewis.com/topics/coronavirus-covid-19)

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to [subscribe](#) using the purple "Stay Up to Date" button.



# Biography



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**David** represents and counsels clients in a range of matters related to employee benefit plans and executive compensation agreements. He advises on the design and implementation of tax-qualified, nonqualified deferred compensation, equity compensation, and health and welfare plans, and he helps clients draft and negotiate executive employment agreements, severance arrangements, and change-in-control arrangements. David's clients include tax-exempt organizations, and public/private Fortune 500 and emerging growth companies in the technology and life sciences fields.

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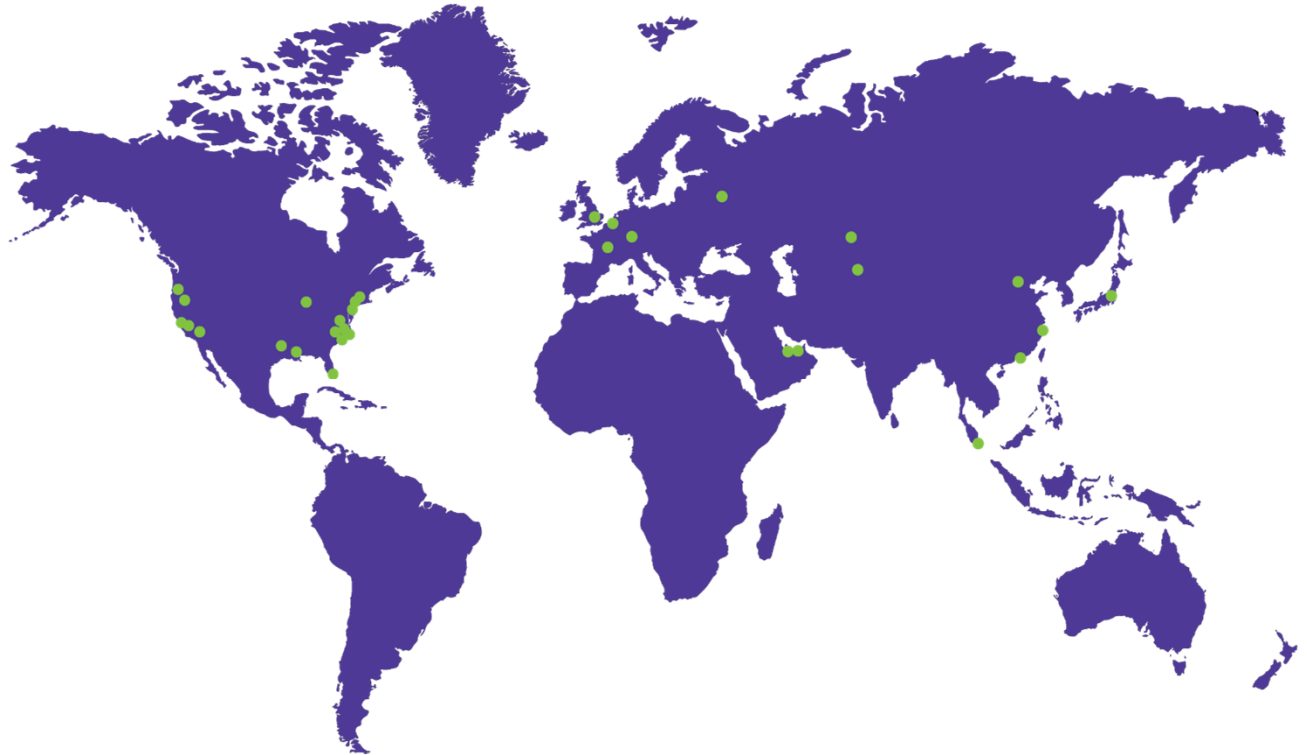
**Sami** is part of our team of lawyers advising public and private clients on a wide range of employee benefits and executive compensation matters. While in law school, Samantha served as a member of *The Tax Lawyer*, an executive board member of the Corporate and Financial Law Organization, and as a member of the Women's Legal Alliance.

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