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# Deferred Compensation Arrangements – Key 409A Issues

**Presentation for:**  
Employee Benefits Academy  
February 25, 2021

**Presentation by:**  
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- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
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  - This presentation is being recorded for internal purposes only
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# Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human Resources
- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

# Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation





# Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

## Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

## Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

## Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

## Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

## Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

## International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

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# Purpose of this Presentation

- The purpose of this presentation is to cover deferred compensation arrangements and key issues under Section 409A of the Internal Revenue Code (“Section 409A”)
- To that end, this presentation covers:
  - Reasons for enactment;
  - An overview of Section 409A applicability and requirements;
  - Restrictions and general exemptions under Section 409A;
  - Provisions in employment agreements that often lead to Section 409A considerations; and
  - Available corrections procedures

- Section 409A is intended to curb perceived abuses related to nonqualified deferred compensation and is a response to the collapse of Enron
- Weeks prior to Enron's filing for bankruptcy protection, Enron permitted approximately 126 highly compensated employees to receive early distributions of nonqualified deferred compensation, totaling more than \$53M
- In the bankruptcy, the remaining employees' deferred compensation accounts were frozen and the employees became unsecured creditors of Enron
- Section 409A is the first time the Internal Revenue Code has provided rules regulating the taxation of nonqualified deferred compensation, which outline the specific requirements for the timing of deferral elections and the designation of the time and form of payment of deferred amounts

- Section 409A applies to US taxpayers
- Section 409A applies to “non-qualified deferred compensation plans”
  - Non-qualified deferred compensation plan – a legally binding right during one taxable year to a payment that is or may be made in a later taxable year
- Unless an exemption applies, it would cover many compensation programs, including, but not limited to:
  - Traditional deferred compensation plans
  - Severance plans
  - Bonus programs
  - Long-term and short-term incentive plans
  - Reimbursement programs
  - Employment arrangements that contain bonus or severance
  - Retention agreements
  - Change in control agreements
  - Compensation and equity provisions in merger agreements

# Why Comply with Section 409A?

- The tax penalties for noncompliance with Section 409A are severe and are imposed on the **employee**
- Failure to comply with Section 409A can result in excise taxes and a premium interest tax (in addition to regular income and payroll taxes)
  - 20% excise tax on all vested amounts (*i.e.*, amounts no longer subject to a substantial risk of forfeiture)
- The premium interest tax is the IRS underpayment interest rate plus an additional one percent
  - The premium interest rate is calculated based on the underpayment that would have occurred if the amount had been includible in income in the taxable year when first deferred, or if later, when vested

- There are 9 categories of plans under Section 409A, and all plans and arrangements within the same category with respect to a single service provider are treated as a single plan
- This means that failing to comply with Section 409A for one arrangement or plan may cause a significant amount of the employee's deferred compensation to be taxable
- Categories:
  - Elective account balance plans
  - Non-elective account balance plans
  - Non-account balance plans
  - Involuntary separation pay plans or window programs
  - In-kind benefits and reimbursement programs
  - Split-dollar life insurance
  - Stock rights (other than those exempt from Section 409A)
    - Ex: Stock options and stock appreciation rights (SARS)
  - Foreign plans
  - Other

- Other areas where plan aggregation has significant impact are initial deferral elections and plan termination
  - There are special rules for initial deferral elections in the first year that a service provider becomes eligible to participate in a plan. This determination of eligibility is based on an aggregated plan basis
  - There are different types of plan terminations, but generally a plan termination will require that all plans that are aggregated for all service providers be terminated



# What Does Section 409A Require?

- A written plan document that includes (at a minimum):
  - The amount to be paid, or in the case of an amount determinable under an objective, nondiscretionary formula, the terms of such formula
  - Time and form of payment (ex. payment schedule and/or triggering event)
  - Initial deferral election
  - Subsequent deferral election
  - Six-month delay for “specified employees”
    - A plan that provides for distributions upon a separation from service must provide that distributions to a specified employee generally may not be made before the date that is six months after the separation from service
    - Must be written in the plan on or before the date that a service provider who has a right to the deferred compensation under the plan becomes a specified employee. This language may be included in the plan even if none of the service providers are specified employees to avoid an inadvertent violation of Section 409A when the company becomes publicly traded or a plan participant becomes a specified employee
    - Plan must specify how the six-month delay will be implemented (whether all amounts otherwise payable during the six-month delay will be paid in a lump sum on a fixed date following the delay or all payment will be delayed for six-months)
- Strict operational compliance
- Unless there is an exemption or the subsequent deferral rules are followed, payment timing may not deviate from the plan terms

# General Exemptions from Section 409A

- US tax-qualified employer plans
  - Ex: 401(k) plans, 403(b) plans, or traditional funded pension plans
- Non-taxable welfare benefits
- Stock options or stock appreciation rights with a strike price at FMV and no deferral features
- Incentive stock options
- Employee stock purchase plans
- Restricted stock (or other property governed by Section 83 of the Code)
- Short-term deferrals

- Any amount paid under a compensation program is **not** deferred compensation if an employee actually or constructively receives payment of the entire amount by the later of:
  - 2 ½ months from the end of the employee’s first taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or
  - 2 ½ months from the end of the employer’s taxable year in which the amount is no longer subject to a substantial risk of forfeiture
- Practically, this exception is important because it allows employers to grant bonuses and other payments while eliminating Section 409A concerns. Also, this exception may apply to severance paid in a lump sum at the end of termination depending on the circumstances triggering payment

# Substantial Risk of Forfeiture (SROF) Defined

- For purposes of applying the short-term deferral exception, it is necessary to determine exactly when the substantial risk of forfeiture with respect to the compensation lapses
- A SROF exists if a service provider's entitlement to an amount is conditioned on either:
  - The performance of substantial future services
  - The occurrence of a condition related to a purpose of the compensation which relates to:
    - the service provider's performance; or
    - the service recipient's business activities or organization goals

- General rule: An election by a service provider to defer compensation must be made (and become irrevocable) no later than the end of the taxable year before the taxable year in which the services are performed to which the compensation relates
- Exceptions:
  - New hire, newly eligible employee or new plan: 30 days to make deferral election (applies only to compensation earned following the election)
  - Performance-based compensation: generally an election is permitted on or before the date that is 6 months before the end of the performance period, provided that:
    - the performance period must be at least 12 months long
    - the employee must perform services continuously from the later of the beginning of the performance period or the date the performance criteria are established through the date the election is made; and
    - the election to defer performance-based compensation is not made after such compensation is readily ascertainable

- Exceptions:
  - Rule for Certain Forfeitable Rights: Where the deferred compensation is subject to a requirement to provide services for at least 12 months, an election may be made no later than 30 days after the legally binding right to the compensation arises (e.g. the date of grant) BUT ONLY if the election is made at least 12 months in advance of the earliest date at which the vesting could occur (excluding earlier vesting upon death, disability, and change in control)
    - Note: the 12-month clock does not start until after the election is made

- Six permissible Payment Events:
  - Separation from Service
    - Payments to “specified employees” (“key employees” of publicly traded corporations) may not be made until 6 months after the date of separation from service
  - Disability
  - Death
  - A specified date or fixed schedule specified in the plan
  - Change in control
  - Unforeseeable emergency
  
- A plan may specify the period of time within which a payment will be made in connection with the specified payment event
  - Payments are Section 409A-compliant if made: (i) by the later of (x) the end of the calendar year in which the trigger occurs, and (y) the 15th day of the third month following the date the trigger occurs; and (ii) up to 30 days before the payment event
  - If it is possible the designated period will span two different taxable years, the payment must be made within 90 days of a permissible payment event
  - The service provider may not be able to designate the taxable year of payment

- A separation from service occurs when the facts and circumstances indicate the employer and employee both reasonably anticipate at the time of separation that either:
  - (i) the employee will perform no further services for the employer/affiliates, or
  - (ii) the level of services that the employee will perform will be no more than 20% of the average level of services the employee performed in the prior 36 months
- An employee is presumed not to have separated from service when the level of service performed is 50% or more of the average level during the prior 36-month period
- No presumption applies where the level of services falls within 20% and 50% of the average level during the prior 36-month period
- Whether a separation from service has occurred is a facts and circumstances test



- Acceptable forms of fixed payment dates:
  - It can be explicitly stated
    - Example: January 1, 2021
    - Example: 2021 (Can be limited to a calendar year)
  - It can be stated in a different form
    - Example: When he/she reaches a specified age or on a specific anniversary of when the grant was made

- The Change in control must qualify as a “change in control event” under Section 409A
- This definition is highly complex and technical but generally includes a change in:
  - Ownership of the corporation
  - Effective control of the corporation, or
  - Ownership of a substantial portion of the assets of the corporation
- The corporation undergoing the change in control must be a relevant corporation within the meaning of Section 409A, such as the corporation for which the service provider performs services

- The following might be considered unforeseeable emergencies under Section 409A:
  - An illness or accident of the employee or employee’s spouse, beneficiary or dependent
  - The loss of the employee’s property due to casualty
  - Imminent foreclosure of or eviction from the employee’s primary residence
  - The need to pay medical expenses
  - The need to pay funeral expenses of a spouse, beneficiary or dependent
  - Other similar extraordinary and unforeseeable circumstances arising from events beyond the control of the individual
- Payments cannot exceed the amount needed to satisfy the emergency
- If the emergency can be satisfied through the liquidation of assets, insurance reimbursement or ending plan deferrals, payments may not be made

- Generally, Section 409A permits only one time and form of payment for any one permissible payment event. This is called the “anti-toggling rule.”
- Examples:
  - A plan cannot provide lump sum upon a involuntary termination from service and 10 annual installments upon a voluntary termination
  - A plan provides for a change in control bonus to be paid in a lump sum upon an asset sale and in a series of installments upon a merger. This violates the anti-toggling rules because the plan provides for two different times and forms of payment, even though the triggering event is a change in control event
- Exceptions:
  - A separation from service during a period not to exceed two years immediately following a Section 409A-compliant change in control;
  - A separation from service before or after a specified date or combination of specified date and specified period of service; or
  - A separation from service that does not fall into either of the two categories above

- Section 409A generally does not allow subsequent changes in time or form of payment
- However, an employer or the employee may elect to **delay** the payment or change the form of payment if:
  - The election will not take effect until at least 12 months after the date the election was made;
  - The new payment date is at least 5 years later than the date the payment otherwise would have been made (for payments made at a specified time or pursuant to a fixed schedule, upon a separation from service or upon a change in control); and
  - The election is made at least 12 months before the date of the first scheduled payment date

- General Rule: The date when the deferred amounts are scheduled to be paid cannot be accelerated
- Exceptions – all or a portion of the payment can be made before the scheduled payment in certain circumstances, including:
  - To fulfill a domestic order
  - To cash out plan balances that are less than the Section 402(g) of the Code limit (\$19,500 for 2021)
  - To pay certain employment taxes, state, local and foreign taxes related to the deferred amount
  - If the deferred amount violates Section 409A and should be included in income
  - Permissible plan terminations
- No “haircut” provisions allowed
- Other prohibitions:
  - The addition of a new payment event
  - The deletion of a permissible payment event
  - The substitution of one permissible payment event for another permissible payment event

- Acceleration of time and form of payment is permissible in the following circumstances:
  - The plan is terminated and liquidated within 12 months of a corporate dissolution or with a bankruptcy court's approval
    - Distributions must be made no later than the latest of (a) the calendar year of the termination, (b) the calendar year of vesting, or (c) the first calendar year in which payment is administratively practicable
  - The plan is terminated within 30 days preceding or 12 months following a change in control
    - Distributions must be made within 12 months after plan termination
    - All plans aggregated with the terminated plan with respect to each service provider who experiences the change in control must be terminated
  - Any termination that is not proximate to a downturn in the service recipient's financial health
    - Distributions must be made no earlier than 12 months and not later than 24 months following plan termination
    - All plans that would be aggregate with the terminated plan as if there were one service provider that participated in them must be terminated
    - Service recipient may not adopt a plan that would be aggregate with the terminated plan for 3 years

- Certain severance payments are treated as exempt from Section 409A if the severance pay:
  - Is payable only on an involuntary termination
  - Does not exceed 2x the lesser of the employee's annual compensation for the year before the termination of employment or the IRS limit on compensation under a qualified pension plan for the year of termination of employment
    - If employment begins and ends in the same year, use the annualized compensation
  - Is paid by December 31st of the second year after the year of termination



- Stock Options and SARs exempt if:
  - The exercise price is not less than the FMV of the stock on the grant date
  - The grant does not permit the employee to defer the income realized on exercise
  - The underlying shares are “service recipient stock”
- Restricted Stock Units, Performance Units, & Phantom Shares
  - Can be structured to be exempt from Section 409A under the short-term deferral rule if they are settled shortly after they vest
    - To comply with the short-term deferral rule, the stock or compensation should be delivered to the employee within 2½ months after the end of the taxable year in which the award vests
  - Otherwise must be structured to be compliant with Section 409A

- Annual bonuses
- Long-term bonuses
- Equity awards
- Reimbursements and outplacement benefits
  - Special rules apply
- Severance payments
  - Good Reason definition
  - Short-term deferral rule
  - Separation pay exception
  - Termination of employment definition
  - Release requirement
- Change in control benefits
- Savings/Boilerplate language
  - Interpretation of plan consistent with Section 409A
  - Six-month delay
  - Separate payment
  - Reimbursements

- Types of failures for which corrections procedures are available:
  - Operational failures (when the plan or document is properly drafted but the deferred compensation arrangement is not administered according to its terms)
  - Documentary failures (errors in the written plan or document)

- Notice 2008-113:
  - Provides a specific correction method for each type of operational error
    - Failures to defer compensation and premature payments
    - Excess deferrals and late payments
    - Discounted stock options and SARs
  - Can only be used for specific violations listed in the notice
  - Can only be used to correct inadvertent errors made in good faith
  - Employer must take commercially reasonable steps to avoid making the same error again
  - Employee cannot currently be under audit by the IRS
  - Employer must attach a statement to its tax return for the year in which the error was discovered that describes the error and correction and identifies the employees affected by the error and their SSNs
  - Generally, the employer must provide a statement to each employee affected by the error
- Corrections are not permitted after the second year after the taxable year in which the error occurs

- Notice 2010-6:
  - Provides corrective amendments to plans that can be adopted for certain plan provisions
  - Only available for violations specifically listed in the notice
    - Ex: ambiguous definitions of payment events
  - Only available for inadvertent errors made in good faith
  - Generally, amendments must be made before action is taken under a noncompliant provision
  - Neither the employer or employee can be under audit by the IRS
  - Employer must attach a statement to its tax return for the taxable year in which the correction is made (except for corrections of ambiguous plan terms), and the employee must attach a statement to its return for the taxable year in which the correction is made and for a later taxable year if it is subject to a partial penalty
- Partial penalties may apply even if a correction is made