The Metropolitan
Corporate Counsel®

www.metrocorpcounsel.com

Volume 16, No. 7 July 2008

Employers Note: §409A Extends To Arrangements Never Thought To Constitute Deferred Compensation – Part I

The Editor interviews ***Charles A. Bruder*** *and* ***David T. Harmon****, Norris, McLaughlin & Marcus, P.A. Part II of this interview is scheduled to appear in the August issue of* The Metropolitan Corporate Counsel.

Editor: Will each of you gentlemen tell our readers something about your practice?

Bruder: I am an employee benefits lawyer for Norris McLaughlin & Marcus and co-chair of the firm's Executive Compensation & Employee Benefits Group. In this position, I have been involved in all aspects of employee benefits arrangements, including tax-qualified and non-qualified retirement plans, stock option plans, and a variety of executive compensation and incentive compensation arrangements. My practice also involves many types of equity compensation and incentive plans, group health plans, general employee welfare benefit plans and different types of severance & termination arrangements.

Harmon: I am a partner in the Corporate Department of Norris, McLaughlin & Marcus. I co-chair the Executive Compensation and Employee Benefits Group. Much of my practice involves structuring and negotiating executive compensation packages, including employment and separation agreements. My practice also involves representation of institutions of higher education and small and medium-sized companies.

Editor: How has this area of expertise evolved and changed over the course of your career?

Charles A. Bruder

David T. Harmon

Bruder: In the past, employee benefits and executive compensation were essentially cash-based. Then, beginning approximately in the mid-1980s – commensurate with the proliferation of software and high tech companies – many start-up enterprises were looking for ways to provide employee benefits and incentive compensation to their executives without a significant outlay of cash. With a start-up company, very often there is little in the way of capital to be paid out to individuals, other than perhaps in the form of company equity. Benefits practitioners began to see, and to contribute to the development of, a variety of incentive-based compensation arrangements which included deferred compensation features. What we have seen over the past 15 or 20 years is a movement away from strictly up-front cash-based compensation to many arrangements with an equity component and/or a compensation deferral to some point in the future, often after the employee's retirement or employment termination has taken place.

Harmon: Another development we have seen is an increase in the variety of corporate perquisites as part of the overall compensation package. A fair amount of imagination has gone into developing these packages, and their value to individual executives can be considerable.

Bruder: I would add that in an economic climate where cash is tight – and the current economic situation is a case in point – corporate perquisites and other forms of non-cash compensation become particularly important. In light of today's uncertain economic conditions, I think we are going to see more and more creativity in this area of incentive compensation.

Editor: You've mentioned §409A. What are the key aspects of the statute?

Bruder: In order to understand the key aspects of Code §409A some background is in order. Prior to the inception of §409A, the Internal Revenue Code offered little in the way of guidance with respect to deferred compensation, which usually simply involved a company's promise to pay its executives a stated amount of money in the future with little in the way of conditions or restrictions. In response to a number of corporate scandals, however, Congress felt that more guidance was needed in this area, which resulted in the enactment of Code §409A. The enactment of this statute has had a significant impact on the structure of these types of arrangements. For example, prior to its inception, if an executive wished to take an early payment of his deferred compensation, he could do so by taking what was known as a "haircut," a percentage of the amount that he would otherwise have received in the future. What concerned Congress was the situation where the company was in dire straits financially, or even insolvent, and the executives, who were in a position to

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know about the company's condition, walked away with all the cash, leaving the shareholders with worthless stock and nothing with which to pay the company's debts. What Code §409A has done is to provide a strict set of rules with respect to deferred compensation. If the company wishes to make a deferral of compensation to an executive that creates a legally binding right to such compensation in the executive, certain rules must be met, and if they are *not* met, negative financial consequences will ensue.

Harmon: It is important to understand that avoiding the negative financial consequences to which Charles refers is largely a matter of how the agreements are structured, and this is equally crucial to both the company and the individual executive.

Editor: In counseling their employers on the appropriate manner to address §409A, what types of arrangements should attorneys be reviewing?

Bruder: Well, §409A includes a very broad definition of deferred compensation. Effectively, any legal right to a payment of compensation which is earned in the current year but payable in a future year is generally viewed as deferred compensation. I say generally because there are exceptions. Compensation paid within two and a half months of the end of the year in which it is earned is not subject to Code §409A, for example. But the reach of the statute's broad definition extends to almost all traditional salary or bonus deferrals, *and* it extends to things that employers did not usually recognize as deferred compensation in the past, including severance arrangements, termination arrangements with salary continuation components, bonus arrangements which are paid out over a number of years, and employment agreements with provisions which result in the deferral of income or the payment of incentive-based compensation in the future. Even directors' fees, where the directors are not being compensated currently but are to be paid in the future, come within the definition of deferred compensation. Certain equity arrangements – stock appreciation rights and phantom stock arrangements, for example – often have a deferred compensation feature that makes the definition applicable. Often overlooked in this connection are stock options with a strike price that is less than the fair market value of the stock as of the date of the grant. Under Code §409A, such arrangements are seen as inherently deferred compensation and subject to the restrictions of the statute.

Harmon: Much of the §409A work that we are currently doing is a reflection, I believe, of executives looking at the full landscape of their compensation package, including cash compensation, equity compensation, a variety of corporate perquisites, and the legal ramifications of deferring some aspect of the package.

Editor: What is the potential impact of an employer's failure to comply with the provisions of Code §409A? Who bears the financial burden of non-compliance?

Bruder: The potential financial impact of a violation of Code §409A can be substantial. And it is the employee who bears that potential impact. In general terms, Code §409A provides that if an individual has a legally binding right to receive deferred compensation in the future – a right which is not subject to a substantial risk of forfeiture – and the provisions of the statute are not followed, then the deferral of the tax on that income is effectively lost. That is, instead of deferring the income tax liability until the date of actual payment of this compensation, the individual becomes liable for the full amount of income tax due on the date the grant of compensation is made, irrespective of when it is actually paid. This tax liability is in addition to interest which may be payable from the date of the grant. The statute also provides for penalties for failure to report income in the prior year, *i.e.*, the year of the grant. If all of this is not sufficient to encourage compliance with Code §409A, failure to comply leads to a 20 percent excise tax on the full amount of the deferred compensation.

Editor: When is full compliance with the provisions of §409A required?

Bruder: The IRS has issued a number of regulations since the enactment of the statute, and under the final regulations compliance is generally required of employers no later than January 1, 2009. Over the past couple of years, the IRS has imposed "good faith" operational compliance requirements on employers, which means that deferred compensation arrangements do not have to be updated until the end of the current calendar year, but such arrangements need to be operated in accordance with the guidelines of the Code section. Generally, as the regulatory framework has evolved through proposed regulations, public commentary and final regulations, the IRS has been giving employers some leeway with respect to compliance. That is, employers have been expected to have their deferred compensation arrangements operate in accordance with IRS guidance even if their documents are not up to date. But, all of this latitude comes to an end by January 1 of next year, and employers must be in full compliance by then.

Editor: The IRS currently sponsors a program under which employers who incur errors in their tax-qualified retirement plans can voluntarily make corrections to these plans without jeopardizing the plan's status. Is there a similar program sponsored by the IRS for §409A compliance?

Bruder: There is a voluntary compliance program sponsored by the IRS, which has been in the process of evolution over the past year. In general terms, employers are required to comply with §409A with respect to their deferred compensation arrangements currently, and the documentation relating to those arrangements must be in compliance by the end of this year. Having said this, let me add that the IRS appears to understand that full compliance with the provisions of the statute may be something of a stretch for some employers within this time period. The IRS has developed, accordingly, a limited voluntary compliance program. With respect to certain unintended operational failures which are identified and corrected within the same year, the IRS is going to permit limited self-correction on the part of employers, and such self-correction will avoid the penalties and income tax acceleration imposed by Code §409A. This program is also extended to deferred compensation arrangements which have certain other minor errors, and the correction period for such errors extends through the 2009 calendar year. Your readers should note, however, that these minor errors are limited in scope and application. We understand that the IRS is looking to expand this program, and the hope is that it will become similar to the program for tax-qualified retirement plans. But the focus of employers which sponsor deferred compensation arrangements should be on being in full compliance with all of the provisions of Code §409A.