The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

Volume 16, No. 8 © 2008 The Metropolitan Corporate Counsel, Inc. August 2008

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

The Editor interviews ***Charles A. Bruder*** *and* ***David T. Harmon****, Norris, McLaughlin & Marcus, PA. Part I of this interview appeared in the July issue of* The Metropolitan Corporate Counsel *and can be found on our website at www.metrocorpcounsel.com.*

Editor: What should legal counsel be doing now to ensure that employers will be in full and timely compliance with Code §409A?

Harmon: This is largely a matter of identifying that full and timely compliance is an *immediate* issue. Counsel should be prompt in making clients aware of the requirements of the statute – an audit of all employment, plan and benefit documents is appropriate in these circumstances to assess which documents require changes as the Code §409A deadline approaches.

Bruder: It is important that counsel for employers carefully review *all* the documents we have talked about to identify areas in which deferred compensation may occur. I cannot stress enough that once those arrangements have been identified, it is imperative to get the appropriate documentation in place as quickly as possible in order to meet the end-of-year deadline. It is also essential to confirm that good faith operational compliance has occurred over the last couple of years with respect to those arrangements.

Editor: Under what circumstances will a gross-up be applicable or available in light of Code §409A?

Bruder: It is important to understand how this circumstance – the payment of a gross-up – could lead to deferred compensation. In general terms, what we are talking about is some taxable event that may occur in the future, and the employer is agreeing to effectively pay all or a portion of the income tax imposed on the executive in connection with that event. The payment of that tax amount by the employer is by definition compensation to the individual. And, because it may not be paid until some point in the future, it is deferred compensation. Gross-ups are, accordingly, one of those items that may not look like deferred compensation but under the broad definition enacted under Code §409A constitute the kind of trap that employers may encounter if they do not proceed with care. The final Treasury Regulations promulgated under Code §409A make clear that certain timing rules apply to tax gross-up payments made by employers, and these timing rules must be satisfied for the arrangement to avoid a violation of Code §409A.

Charles A. Bruder

David T. Harmon

Harmon: Gross-ups are certainly a legitimate subject of negotiation between the employer and the employee in an employment contract or a severance arrangement. It is essential, however, for both parties to understand the deferred compensation consequences of any such contractual arrangement and to make sure the arrangement is in full compliance with the statute.

Editor: What are some of the Code §409A issues that need to be addressed in employment agreements?

Bruder: Getting back to a point that we discussed earlier, very often an employment agreement will include some provision that calls for a payment of compensation at a future date or upon the occurrence of some future event. Almost invariably such a provision is going to be deferred compensation irrespective of what was contemplated by the parties when the agreement was negotiated, and the effect of Code §409A must be considered. If the provisions of the agreement are not in compliance, all of the negative financial impacts we have discussed come into play. In light of what is at stake in terms of ordinary income tax, excise tax and interest, it is crucial that all undertakings that might possibly be considered deferred compensation be reviewed forthwith and, if not compliant, brought into line as soon as possible and certainly by the end-of-the-year documentary compliance date.

Another potential Code §409A issue has to do with employment agreements which include compensation features that are equity-based. Depending on how such provisions are structured, Code §409A may be applicable. We have counseled our clients accordingly and recommend that *any* equity-based incentive compensation arrangement reflected in an employment agreement be reviewed for Code §409A compliance.

Please email the interviewees at cabruder@nmmlaw.com or dtharmon@nmmlaw.com with questions about this interview.

Harmon: The immediate issues derive from the necessity to structure an arrangement so as to reflect good faith compliance with Code §409A and full documentary compliance by the end of the year. The question of indemnification of the executive by the company is not insignificant. In structuring these arrangements it is wise to consider whether, and to what extent, the executive can look to the company for a tax gross-up in the event a Code §409A penalty is imposed on a particular arrangement.

Editor: How is termination of the employment relationship affected by Code §409A?

Bruder: Code §409A specifically addresses a couple of technical issues in connection with termination of employment. First, in order for a permissible payment of deferred compensation to take place, a trigger event must occur. One of those trigger events is a separation from service. The provisions of Code §409A include a very specific definition of separation from service. In general terms, an individual whose employment is terminated won't have a problem meeting that definition and therefore will be eligible to receive a permissible payment of deferred compensation. However, very often – where a key executive is involved or a contract of employment specifically so provides – an executive will terminate his employment as an employee but subsequently will be retained as a consultant to the company. The provisions of Code §409A and specifically the final regulations address this circumstance and provide specific guidelines under which a former employee can provide consulting services to the company. If the executive provides significant consulting services, for example, he will not been deemed to have had a separation from service. In that situation the payment of deferred compensation is impermissible.

Another provision of the statute requires that if the executive is a specified employee and entitled to a payment on termination of employment, there must be a six-month delay in the payment date. This is intended to ensure that the capital of the company is available to meet certain contingencies – the Enron type of situation, where the executives left with all the cash and the company was rendered effectively insolvent, comes to mind – and in structuring an employment agreement both parties should be aware of the fact that immediate payment on termination may not be available.

Let me also mention that Congress, in its wisdom, provided a safe harbor with respect to certain severance arrangements. In general terms, as long as the individual who is voluntarily leaving his or her employment is not receiving a payment that is more than two times his or her base salary, and provided that amount is going to be paid out within 24 months of the date of termination, the provisions of §409A do not need to be satisfied. That is, if the deferred compensation arrangement is structured within the safe harbor, it need not meet the requirements of the statute.

Harmon: Structuring an employment agreement with specific attention to the post-termination compensation structure requires careful accounting to ensure §409 compliance. Parties may negotiate §409A indemnification by the company in certain circumstances. Allocation of risk regarding §409A compliance is an issue that should be addressed in the negotiation of a comprehensive employment agreement.

Editor: How has the enactment of §409A impacted the current trends in structuring executive compensation arrangements?

Harmon: The implementation of Code §409A has had an enormous impact on the education of the parties to employment and severance agreements, or at least it has had that effect on the lawyers who serve those parties. The statute compels us, as practitioners in this area, to ensure that our clients understand the need for compliance and the risks associated with a failure to do so.

Bruder: One of the areas where the statute has had considerable impact on structuring executive compensation arrangements is change of control situations. In general terms, Code §409A does not allow for any alteration in the timing of a payment of deferred compensation to an individual. There can be neither an acceleration of payment nor a deferral of payment other than within the original structure of the arrangement. There are, however, certain exceptions. If there is a change of control of the company – if it is taken over by some other company or sells a significant asset – then, provided the definition of change of control of Code §409A is met, that triggering event enables the executive to receive a deferred compensation payment without penalty. Even if the arrangement provides for payment many years in the future, a change of control that meets the definition results in permissible deferred compensation. Under certain circumstances, even a partial sale of the company may trigger a permissible payment of deferred compensation. Accordingly, it is important for counsel to structure these arrangements with a great deal of care. If it is intended that the executive be entitled to the payment of deferred compensation on a partial sale of the company, the agreement should so specify in compliance with Code §409A. And if the intention is to pay the executive only in the event of a change of control, it is important for the agreement to define change of control with direct reference to Code §409A.

Editor: Is there anything that you would like to add?

Bruder: In recent years deferred compensation has become a far more important element in executive compensation than it was in the past. In our discussion we have been focused on Code §409A – which, of course, has been enacted in direct response to the need to bring some regulatory structure to the deferred compensation area – but the tax implications of any compensation arrangement, deferred or otherwise, are important. When structuring these compensation arrangements, deferred or otherwise, counsel must take into account a whole range of taxation issues. If, however, deferred compensation is a feature of the arrangement, Code §409A must be paramount in his mind. That is because the negative financial consequences are so onerous that a failure to comply could have immense consequences for both the executive and the company. To be sure, it is the executive rather than the company who bears the brunt of this statute, but an angry CEO who has performed well on behalf of the company and its shareholders, only to see the benefits of that effort evaporate in penalties, taxes and interest, is not necessarily going to provide the kind of leadership the company expects. Counsel to the company has as much interest in getting the Code §409A compliance aspect of the employment agreement right as counsel to the executive. I would make the same assertion with respect to such compensation arrangements as equity-based incentive compensation, stock options and stock appreciation rights and the variety of corporate perquisites that have come to the fore in recent years. Whether governed by Code §409A or not, these arrangements contribute to the well being of the company and its shareholders. Conversely, if not properly structured, they can contribute to extremely adverse outcomes for the company.