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409A Issues in Executive Compensation Contracts and Employment Agreements

409A Basics

Section 409A of the Internal Revenue Code of 1986, as amended (409A), was enacted into law in 2004 to impose statutory requirements on "nonqualified deferred compensation plans, programs or arrangements" (collectively referred to herein as a "plan" or "plans"). In general, 409A requires all nonqualified deferred compensation plans to specify in writing, upon the inception of the plan, the "time" and "form" of payment and, except in limited circumstances, prohibits the acceleration or subsequent deferrals after a "plan" has been established. A violation of these requirements results in all vested (whether or not paid) amounts becoming immediately taxable as compensation income, subject to all applicable income and payroll tax withholding and an additional 20% penalty tax on the compensation income.

The difficulty with 409A is its overly broad definition of what constitutes a nonqualified deferred compensation plan. The 409A Treasury Regulations define a nonqualified deferred compensation plan as any plan, agreement, program or arrangement that provides a "service provider" (includes employees and nonemployee contractors) with a "legally binding right" to compensation payable in a later tax year. This broad definition covers bonus payments, equity compensation, severance arrangements and other forms of compensation and benefits that are payable pursuant to an executive compensation contract or employment agreement.

To satisfy the "time" and "form" of payment requirements. With respect to the "time" requirement, the "plan" must specify in writing that payment will be made upon any one, or the earlier of two or more, of the following six permissible payment events: (1) the employee's "separation from service," (2) the date the employee becomes "disabled," (3) the employee's death, (4) a specified date (or pursuant to a fixed payment schedule), (5) a change in control or (6) the occurrence of an "unforeseeable emergency." A payment will be in compliance with 409A as long as it is paid by December 31 of the year in which the permissible payment event occurs. With respect to the second requirement, the "form" of payment, the plan must specify in writing whether the deferred compensation will be paid in a lump sum or in installments under a fixed payment schedule.

The remainder of this article provides a summary of the more common 409A issues that arise when drafting and negotiating executive compensation contracts and employment agreements.

Bonuses

A bonus provision that is included in an executive compensation contract or employment agreement will be subject to 409A if the bonus is paid later than the 15th day of the third month following the end of the year in which the bonus is earned (the "shortterm deferral window"). Any bonus that is paid prior to this date will qualify as a "shortterm deferral" and will be exempt from 409A. A bonus arrangement that does not qualify as a "shortterm deferral" must

comply with 409A, including the time and form of payment requirements. If the agreement is silent, 409A presumes the payment date to be the first day of the following year. In such case, the employing company will have until the last day of the year in which the permissible payment date occurs to make the bonus payment. The logic here is that there is no deferral as long as the payment is made within the same tax year as the permissible payment event. A 409A violation will occur, however, if the payment is made beyond the payment deadline. **A bonus provision in an executive compensation contract or employment agreement should provide a payment deadline to qualify the bonus as a "shortterm deferral" or for the purpose of complying with 409A.**

Severance Arrangements

A provision to provide for severance upon termination of employment is the most common form of nonqualified deferred compensation that is included in an executive compensation contract or employment agreement. In many cases, an employee contract will provide for severance payments that are payable in lump sum immediately following the employee's termination date or in the form of salary continuation over a specified period. A contract that provides for a lumpsum severance payment upon termination of employment will qualify as a "shortterm deferral" (as defined above) as long as the severance is payable only in the case of an "involuntary separation of service" and is paid within the "shortterm deferral window." A severance provision that provides for payment in the case of a "voluntary" separation of service will not qualify as a shortterm deferral.

Another 409A exemption that applies to severance payments is the "separation pay safe harbor." Under this exemption, a severance provision that provides for "separation pay" only upon an involuntary separation of service does not provide for a deferral of compensation to the extent the separation pay, or a portion of the separation pay, meets the following requirements:

- The separation pay does not exceed two times the lesser of:
  - The sum of the employee's annualized compensation based on the annual rate of pay for the year preceding the year of termination, or
  - The 401(a)(17) limit for the year in which the termination occurs.
- The plan provides that the separation pay must be paid no later than the last day of the second taxable year of the employee following the year of termination.

Salary continuation longer than two years is uncommon, so the second prong of the separation pay exemption is rarely a problem. The first prong, the amount of the separation pay, is usually the issue. For 2023, the 401(a)(17) limit is $330,000, which means the maximum amount that can qualify under the separation pay safe harbor is $660,000. Many executives are entitled to severance in excess of this amount. It is important to understand, however, that the rule is not all or nothing—the portion of the separation pay that meets the safe harbor requirements will be exempt from 409A.

Many executive compensation contracts and employment agreements allow employees to resign for "good reason" and collect severance. A good reason resignation may constitute an "involuntary separation" from service for purposes of the shortterm deferral and separation pay exemption if certain requirements are met. The general rule is that the circumstances that constitute "good reason," for purposes of 409A, must be defined to include actions taken by the employer that result in a material negative change to the employee's role or duties, compensation, or other circumstances. The 409A Treasury Regulations provide a safe harbor definition for good reason that, if followed, will characterize a resignation for good reason as an involuntary separation from service. It is important to understand that the failure to qualify a good reason termination as an involuntary separation of service does not necessarily result in a 409A violation. Many practitioners make this mistake in negotiations. The only pitfall is that it prevents the separation pay from being exempt from 409A as a shortterm deferral or under the separation pay safe harbor. It will then be essential that the plan is structured to comply with 409A.

Six-Month Delay of Payment

Severance pay that qualifies as a shortterm deferral or is otherwise exempt from 409A under the separation pay safe harbor is not subject to the rule requiring a sixmonth delay of payment. Under this rule, the payment of deferred compensation to a "specified employee," which becomes payable upon separation of service, must be delayed for six months. A "specified employee" generally includes the 50 most highly compensated officers of a public company. The sixmonth delay-of-payment rule applies only with respect to publicly traded companies and to payments that are triggered by the "specified employee's" separation of service. The six-month delay-of-payment rule, however, does not prohibit the earlier payment of compensation that is otherwise exempt from 409A, such as "short-term deferrals." If this rule applies, it must be addressed in the executive compensation contract or employment agreement providing for the separation pay.

Release Agreements

Most employers condition the payment of severance on the employee's execution of a release agreement in favor of the company. Unless certain IRS safeguards are included in the executive compensation contract or employment agreement, the employee will have the discretion to receive the payment (or first installment payment) in the current tax year or delay payment to the following tax year by executing the release in the current tax year or delaying execution until the following tax year. The IRS has approved two approaches for the purpose of eliminating this discretion. Under the first approach, the document may provide that the payment will be made on the 60th or 90th day following the termination date, as long as the release has become irrevocable prior to the payment date. Under the second approach, the document may allow for payment within a period of up to 90 days following the termination date, so long as the document states that if the period spans two calendar years, the payment will be made in the second year. Under either IRS approach, the discretion to be taxed currently or in the following tax year is taken away from the employee.

Equity Compensation

409A does not apply to awards of restricted stock that are taxable under IRC Section 83. Qualified stock options are also exempt from 409A. Nonqualified stock options are exempt if certain conditions are satisfied, the most important of which is that the exercise price of the option must not be less than the fair market value of the underlying stock on the date of grant, which is a particular challenge for privately held companies that award employee stock options. (See Pricing Private Company Stock Options.) Other types of equity compensation awards (e.g., phantom stock awards, restricted stock units, stock appreciation rights) may present 409A issues, but those issues are typically addressed in the respective equity plan or award agreement and not addressed in an employment agreement or offer letter.

Definitions and Savings Clauses

The terms in this article that appear in quotation marks denote a specific 409A meaning or the meaning required for such term by the 409A Treasury Regulations. For example, the term "nonqualified deferred compensation" is compensation subject to 409A. Payments that are exempt from 409A are not "nonqualified deferred compensation." The terms "change in control," "disability," "unforeseeable emergency," and "separation of service" have specific meanings and are each defined in the 409A Treasury Regulations.

Some practitioners address the 409A issues and definitions throughout the employment agreement by referencing the applicable Treasury Regulations. For example, a contract or agreement may provide that the deferred compensation shall be payable upon a "change in control," as defined by Treas. Reg. Section 1.409A3(i)(5)(v). Another approach is to include a 409A savings clause requiring the terms of the employment agreement to be interpreted in a manner that complies with 409A. A savings clause cannot, however, be used to eliminate the right to payment in the event such payment is in violation of 409A. The Treasury Regulations require that such savings clauses be disregarded. Savings clauses can be used, however, to resolve in the drafter's favor any ambiguity regarding the application of 409A. Under Notice 20106, the IRS will allow a plan to include a provision requiring the terms to be interpreted in a manner that complies with 409A.

Conclusion

The foregoing is not intended to be an allinclusive list of the various 409A issues that arise in the drafting and negotiation of an employment agreement, but a sample of the more common issues and how they are addressed. Proper drafting and operational compliance will avoid these issues and prevent the disastrous consequences of 409A.

For more information about Manatt's Executive Compensation and Employee Benefits Practice, please click here.

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For more information, visit https://www.manatt.com or contact:

John Heber
Partner, Tax, Employee Benefits and
Executive Compensation
Manatt, Phelps & Phillips, LLP
415.291.7441
jheber@manatt.com

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