



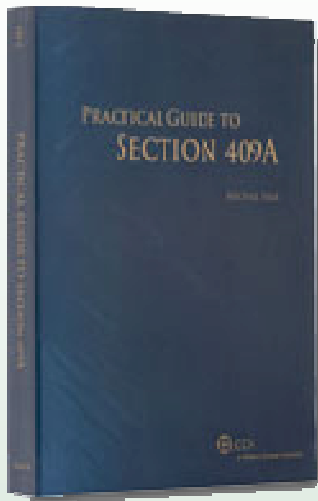
# A Guided Tour Through the Jungles of IRC Section 409A

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# IRC Section 409A



- ◆ What is 409A?
- ◆ Certain situations where 409A issues arise:
  - ◆ Equity compensation
  - ◆ Deferral of salary when finances are tight
- ◆ Reporting requirements



**What is 409A?**



## What is 409A?

- ◆ Applies to so-called “nonqualified deferred compensation plans” (subject to certain exemptions)
- ◆ Specifies rules that all non-exempt plans must follow
- ◆ If rules aren’t followed, then as soon as an employee’s right to deferred compensation vests –
  - ◆ The employee is taxed on that compensation at normal rates, **plus**
  - ◆ The employee must pay an additional 20% penalty tax on the compensation, **plus**
  - ◆ The employee must pay interest for the deferral period



# What is a Nonqualified Deferred Compensation Plan?

- ◆ Any plan under which an employee has a binding legal right to compensation that is **or may be** payable in a later taxable year
- ◆ **Examples:**
  - ◆ ***Contractual deferral:*** Employer and employee mutually agree that \$10,000 of employee's 2010 base salary will be deferred and paid in 2012
  - ◆ ***Traditional deferred compensation plan:*** Employer establishes a long-term incentive plan under which employees accrue formula-based bonus amounts that vest over a five-year period
  - ◆ ***Severance plan:*** Employer agrees to pay employee six-months' severance upon termination of employment
  - ◆ ***Change of control agreement:*** Employer agrees to pay employee a specified amount upon a change of control





## Arrangements Exempt from 409A

- ☑ Qualified retirement plans (e.g. pension, profit sharing, 401(k) plans)
- ☑ Welfare benefits (vacation, sick leave, disability and death benefit plans)
- ☑ Short-term deferrals
- ☑ Severance plans that meet specified requirements
- ☑ Incentive stock options that comply with IRC §422
- ☑ Certain other stock options and stock appreciation rights



## Short-term Deferral Rule

- ◆ Exempts from 409A amounts that can never be “**deferred payments**” and that are paid promptly after the right to the payment is no longer subject to a “substantial risk of forfeiture”
- ◆ A “**substantial risk of forfeiture**” can be thought of as a vesting condition:
  - ◆ **Example:** Employer agrees to pay employee a \$5,000 bonus once she completes three years of service. The right to the bonus vests on the third anniversary of the hire date. Until then it is subject to a substantial risk of forfeiture, namely that the employee will forfeit the bonus if her employment ends.
  - ◆ A non-compete restriction does not create a substantial risk of forfeiture



## Short-term Deferral Rule, cont.

- ◆ Arrangement cannot include the possibility of a “**deferred payment**”:
  - ◆ **Example**: Employer agrees in February of 2010 to pay employee \$5,000 upon termination of employment. Employee terminates in November of 2010 and receives the \$5,000. This is not a short-term deferral, because it was possible that the \$5,000 would have been paid in a later year.
- ◆ Prompt payment requirement:
  - ◆ To qualify as a short-term deferral, the amount must be paid within 2½ months after the end of the year in which the compensation vests
  - ◆ This will typically be March 15 of the following year
  - ◆ If the employer uses a fiscal year, it will still qualify as a short-term deferral if the amount is paid within 2½ months after the end of the fiscal year of the employer in which the compensation vests





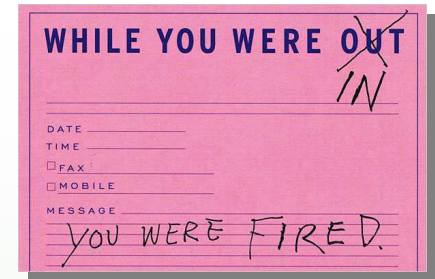
## Short-term Deferral Rule - Examples

- ◆ **Example 1**: Employer, which uses a June 30 fiscal year, agrees in August to pay employee a bonus of \$5,000. So long as the bonus is paid by September 15 of the following year, it will qualify as a short-term deferral.
- ◆ **Example 2**: Employer agrees to pay employee six-months' severance within 60 days after any involuntary termination without cause. Employee could leave voluntarily and not receive severance. Therefore, there is a substantial risk of forfeiture and this is exempt as a short-term deferral.
- ◆ **Example 3**: Same facts except that employee must sign a release before receiving the severance. This is **probably** not a short-term deferral because the employee could delay signing the release until after the end of the 2½ month period.



# Severance Plan Exemption

- ◆ A separation pay plan is exempt if:
  - ◆ It provides for payment only upon an involuntary “**separation from service**” (or certain voluntary resignations for “good reason”)
  - ◆ The amounts paid under the plan do not exceed two times the **lesser** of:
    - ◆ the employee’s annual compensation, or
    - ◆ the Code Section 401(a)(17) limit for the year (\$245,000 in 2010); **and**
  - ◆ The amounts are paid no later than December 31 of the second year following the year in which the separation from service occurs





## Basic Section 409A Requirements

- ◆ Plan must be in writing
- ◆ Timing of the election to defer compensation is limited – election generally must be made in the year prior to the year in which the compensation is earned
- ◆ Subsequent elections to further defer compensation are limited:
  - ◆ Must be made at least one year before the payment would otherwise be made
  - ◆ Must result in an additional deferral of at least five years



## Basic Section 409A Requirements, cont.

- ◆ Events that can trigger a distribution of deferred compensation are limited
- ◆ Acceleration of payment of deferred compensation is prohibited in nearly all circumstances
- ◆ A “**specified employee**” of a public company cannot receive a distribution earlier than 6 months after termination of employment (except for death)



## Permissible Triggers for Payment of Deferred Compensation

- ◆ Separation from service (termination of employment)
- ◆ Death
- ◆ Disability
- ◆ Change of control
- ◆ Unforeseeable emergency
- ◆ Specified date or a payment schedule under which neither the employer nor the employee can affect the timing of the payments





# Separation from Service

- ◆ Termination of employment where –
  - ◆ No further services are performed, or
  - ◆ The employer and employee **anticipate** that the level of services will be less than 20% of the average level of services performed in the previous 36 months
- ◆ Change from employee to independent contractor or vice versa is irrelevant
- ◆ If employee terminates but continues to provide service on the employer's board of directors, the board service is ignored
- ◆ Leave of absence (sick leave, military leave, etc.) is not a separation if the leave lasts less than 6 months or it lasts longer but employee has statutory or contractual right to reemployment



# Change of Control

- ◆ Change in **ownership** of the employer:
  - ◆ A person or group acquires ownership of stock that, together with stock already held, constitutes more than 50% of the total value or voting power of the employer's stock
- ◆ Change in **effective control** of the employer:
  - ◆ A person or a group acquires, during any 12-month period, ownership of stock possessing 30% or more of the total voting power of the employer's stock, **or**
  - ◆ A majority of the board of directors is replaced during any 12-month period without the approval of the existing directors
- ◆ Change in ownership of a substantial portion of the employer's **assets**
  - ◆ A "substantial portion" is at least 40% of the total gross FMV of all the employer's assets before the acquisition.





## Specified Date or Payment Schedule

- ◆ Payment date(s) must be “**nondiscretionary and objectively determinable**” at the time the amounts are deferred
- ◆ Amounts payable must be identified at the time the amounts are deferred, either by actual dollar amount or an objective, nondiscretionary formula
- ◆ Payment date can be linked to another permissible payment trigger (e.g., payment on the first anniversary of a change of control)
- ◆ Payment date cannot be linked to an event that is not a permissible payment trigger (e.g., payment on the first anniversary of an IPO is not permitted)



## Specified Date – Useful Rules

- ◆ Payment due on specified date will be treated as made on that date:
  - ◆ If made on that date or a later date within the same taxable year (or, if later, by the 15th day of the third calendar month following the specified date)



- ◆ **Example 1:** A payment due on June 1, 2010 may be paid up to December 31, 2010.
- ◆ **Example 2:** A payment due on November 10, 2010 can be paid up to February 15, 2011 (as long as employee cannot pick the payment year)
- ◆ If made up to 30 days before the specified date
- ◆ If amount due cannot be calculated, payment can be made during the first taxable year of the employee in which the calculation is administratively practicable



## Specified Date – More Useful Rules

- ◆ If making the payment on the specified date would jeopardize the ability of the employer to continue as a going concern, the payment can be made in the first taxable year of the employee in which it would not have such effect
- ◆ An arrangement is treated as providing for payment on a specified date if it designates a period within a single year or not more than 90 days long during which the payment must be made (e.g., within 80 days after a change of control)
- ◆ If the right to a payment is not vested, payment can be accelerated upon occurrence of an event that is not a permissible payment trigger (e.g., employer can agree to pay a bonus upon completion of three years of service or upon earlier completion of an IPO)



## What are Some Impermissible Payment Triggers?

- ◆ Accelerated payment upon employee's agreement to accept a reduced amount (haircut)
- ◆ Acceleration of payment at employer's option (except in very limited circumstances)
- ◆ Change in job responsibilities
- ◆ Change to part-time employment (unless it constitutes a separation from service)
- ◆ Payment tied to payout under a qualified plan
- ◆ Payment tied to financing (e.g. IPO)





# Equity Compensation



# Equity Compensation

## ◆ Restricted stock and restricted stock units (RSUs)



- ◆ These types of awards are generally taxable as soon as they vest, so they will be exempt under the short-term deferral rule
- ◆ If an award has any type of feature designed to defer taxation beyond the vesting date, then the award will need to comply with 409A

## ◆ Stock options

- ◆ Incentive stock options qualified under IRC §422 are expressly exempt from 409A
- ◆ When a nonqualified stock option (NSO) is exercised, the spread is taxable income. A decision not to exercise a NSO results in deferral of income. However, Congress said that NSOs granted at FMV should not be subject to 409A.



# Nonqualified Stock Options (NSOs)

- ◆ Requirements for 409A exemption of NSOs:
  - ◆ Applies only to options on common stock
  - ◆ The number of shares and the exercise price must be fixed on the date the option is granted
  - ◆ The exercise price is not less than the FMV of the stock on the date of grant
- ◆ Stock appreciation rights are exempt under similar rules
- ◆ Valuation issues
  - ◆ For stock of a public company, the exercise price can be determined based on any reasonable method using actual transactions in stock



# Valuations for Stock Option Grants

- ◆ Valuation issues, cont.
  - ◆ For stock of a private company, exercise price must be determined by applying a reasonable valuation method
  - ◆ A valuation method is not reasonable if –
    - ◆ It is based on a valuation that is more than one year old; or
    - ◆ It does not reflect later information that materially affects the value of the stock (e.g., issuance of a significant patent)
  - ◆ Presumption of reasonableness –
    - ◆ Written valuation by independent appraiser
    - ◆ For early-stage companies (as defined by the IRS), written valuation by a person qualified to perform such valuation
    - ◆ In any case, valuation cannot be more than one year old



## Valuations for Stock Option Grants , cont.

- ◆ What private companies should do
  - ◆ Grant incentive stock options based on good faith determination of value by board
  - ◆ Many pre-venture capital (VC) companies issue options without a valuation report
  - ◆ VC firms typically require portfolio companies to obtain appraisals
  - ◆ If a VC representative is on the board, his expertise may be sufficient for the appraisal report
  - ◆ Cost of appraisals vary: sometimes as low as \$5K but usually \$10K to \$15K (or more for later stage companies)



The background of the slide is a close-up, slightly blurred image of a banknote. A large, circular emblem is visible in the center, featuring intricate patterns and colors. The overall tone is muted, with greens, yellows, and greys. A dark grey horizontal band is overlaid across the middle of the image, containing the title text.

# **Deferral of Salary when Finances are Tight**



# Deferral of Salary

January	February	March
April	May	June
July	August	September
October	November	December

- ◆ Executives of start-ups quite commonly agree to defer salary. To avoid 409A problems –
  - ◆ Defer to a specified date
  - ◆ Defer to an event that is a permissible payment trigger under 409A (termination of employment)
  - ◆ Defer to another event (e.g., the next financing), but only if the employee forfeits the deferred salary if the event doesn't happen – if the event happens, the payment will be a short-term deferral
- ◆ Could also take position that payment would jeopardize the employer's ability to continue as a going concern, but if you do not prevail, employee will have to pay tax (including a 20% penalty tax) on the deferred salary, even though it hasn't been paid.



# Reporting Requirements



# Eventual Reporting Requirements

- ◆ When §409A regulations are finalized –
  - ◆ Amounts deferred under a nonqualified deferred compensation plan (NDCP) will be reported in box 12 of Form W-2, using code Y
  - ◆ Amounts includible in income under §409A will be reported as wages in box 1 of Form W-2, and also in box 12 of Form W-2, using code Z
  - ◆ Similar rules apply to reporting for independent contractors on Form 1099-MISC
- ◆ If an NDCP complies with §409A, amounts that are paid out will be reportable as wages on the Form W-2 (or as income on Form 1099-MISC), but they will not be reportable in box 12 (otherwise the IRS would likely try to assess a 20% penalty tax)



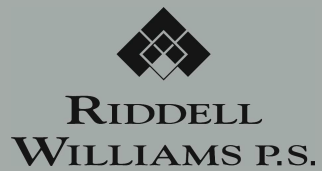
## Interim reporting requirements

- ◆ Under IRS Notice 2008-115, until the year after §409A regulations are finalized –
  - ◆ Amounts deferred under an NDCP do not need to be reported
  - ◆ Amounts includible in income under §409A will be reported as wages in box 1 of Form W-2, and also in box 12 of Form W-2, using code Z
  - ◆ Similar rules apply to reporting for independent contractors on Form 1099-MISC



## Withholding requirements

- ◆ An employer must withhold on amounts includible in employee's income under §409A
- ◆ These amounts are treated as “supplemental wages”, so you can withhold at a flat 25% rate
- ◆ No additional holding is required on account of the 20% penalty tax, although this might change after final regulations are issued
- ◆ If there are amounts that are includible in income for a year under §409A but that are not actually paid, then employer can either withhold from other wages (by February 1 of the following year) or pay the withholding itself without reimbursement from the employee



# Questions?

Please contact me any time with questions.

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