Ten Years Later, Companies Still Striving for a 409A+

By Adam B. Cohen and Carol A. Weiser

In the world of deferred compensation arrangements, Section 409A of the tax code is about as popular as a pop quiz in high school calculus. This complicated tax rule took effect 10 years ago, in 2005, in response to perceived abuses of deferred compensation arrangements. It provides for immediate tax and a 20% additional tax on non-compliant arrangements, both imposed on the employee. Most practitioners and employers would probably give themselves high marks for their compliance strategies with respect to traditional deferred compensation plans, such as elective deferrals or supplemental executive retirement plans. This article highlights arrangements, such as severance pay, that threaten to lower the grade to a B-, and we discuss some opportunities for corporate counsel to bring that grade up to a 409A+. 

Severance Pay: Multiple Choice of Exemptions

Severance pay continues to be an area with substantial Section 409A challenges. These arrangements are entered into frequently and are sometimes fully negotiated before they are ever taken to the lawyers, and there are often strong business reasons for structuring the payment timing and conditions in a particular way. Unfortunately, these arrangements are often subject to Section 409A. 

Severance pay is usually on the edge of Section 409A coverage, with some arrangements completely exempt from coverage under Section 409A, other arrangements completely subject to those rules, and still others partially covered and partially exempt. 

The Section 409A regulations provide an exemption for typical severance pay that does not exceed the lesser of two times the employee’s annual compensation or a specified dollar limit and with installments paid out over not more than 24 months. There is another exemption that covers certain severance arrangements paid in a lump sum or other limited payments, in either case by March 15 of the year following the year of termination. These exemptions cover many severance agreements, especially those providing for smaller dollar amounts paid over shorter periods of time.

However, if severance pay does not fit within the exemptions, then some or all of it will be subject to the various payment timing and other restrictions imposed by Section 409A. For example, an agreement to pay an employee severance in installments over three years would result in at least the payouts in the third year being subject to Section 409A. As another example, an employment agreement that pays severance upon any retirement after a certain age, rather than just upon involuntary termination, would be subject to Section 409A. Similarly, if the payment trigger for severance included a good reason quit that does not satisfy the standards in the final regulations to be treated as an involuntary termination, the severance pay would be subject to Section 409A.

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can arise. One important issue is that the payout trigger must be one of the enumerated permissible triggers under Section 409A. “Separation from service” is one such trigger, but the regulations provide a detailed, and sometimes counterintuitive, definition of what constitutes a separation from service.

For example, if an employee ceases to be a regular employee but continues to serve the company as a consultant working 50% of the employee’s previous hours, the employee would generally not have a separation from service, and the payout timing of any severance that is subject to Section 409A could not be triggered by the cessation of working as an employee.

Also, the opposite can apply: a company might consider an individual on garden leave or salary continuation as continuing to be employed at least for certain purposes. However, if the individual is no longer performing services or performs only minimal services, he or she will have had a separation from service for purposes of Section 409A.

Another issue that arises involves a six-month payment delay. If the severance pay is subject to Section 409A, and the employee is one of the top 50 highest paid officers of a public company, the severance payout would generally have to be delayed by six months following termination of employment. (The six-month delay was intended to address situations in which executives departing a failing or otherwise financially troubled company could nonetheless receive payments of deferred compensation right after leaving employment, further depleting the company’s assets or otherwise getting preference over rank-and-file employees.)

As a result of the complexity surrounding severance pay, it is usually wise for companies to try to involve a Section 409A expert early in the process. Although it is not always convenient to slow down a negotiation or add words to an agreement, especially at the early stages, it is often better than having to go back to the drawing board at the end of the negotiation, or worse, discovering a problem as payments are being made.
Other Termination-Related Issues:
Open-Ended Essay Question

For a company that typically provides a fairly robust severance package or that provides enhanced packages in connection with reductions in force or other group terminations, almost every aspect of the package needs to be considered. There are a number of benefits that companies offer in these packages that can be subject to Section 409A—for example, continued health coverage, enhanced severance paid to provide consideration for a release, payment for a noncompete or other restrictive covenants, an allowance to an expat for the return to his or her home country or other moving or relocation assistance, the ability to buy a company-provided car at cost, amounts paid in lieu of annual bonuses or long-term incentives, outplacement, and amounts paid in lieu of contributions to a retirement plan.

While the Section 409A regulations include exemptions that may be applicable to several of these types of benefits, such as outplacement and relocation benefits, the rules include time limits, and often the best way to ensure the time limits are met is to spell out the rules in the severance agreement or other applicable documents. For other benefits not subject to those Section 409A exemptions, to the extent that the benefits are being negotiated or offered for the first time as the exit package is being set, there may be a fair degree of flexibility in setting the timing for payment, but the time has to be clearly specified in the written agreement, which was not always typically done in the past.

Also, to the extent that payment of severance or any of the other benefits in a severance package is conditioned on the former employee executing a release, the timing of the signing of the release cannot have the effect of causing payments that could be made in one year being shifted to the next year. Therefore, this is another aspect of severance arrangements that can pose a trap for the unwary and on which companies need to consult their Section 409A experts.

Corporate Transactions: Bonus Points

The restrictions of Section 409A come into play in numerous ways in corporate transactions, and these rules can take center stage in complex negotiations that often go to the heart of the transaction. One example is compensation payments that are tied to earn-outs, i.e., amounts paid at a later date, subject to the acquired business having met certain profitability or other goals. One way this comes up is when equity compensation (such as options or restricted stock) held by employees of the target in an acquisition is cashed out at the closing of a deal, the buyers often want to have a portion of the cash-out tied to an earn-out, just as some portion of the payments to the other target shareholders are subject to an earn-out.

Although these types of arrangements generally raise Section 409A issues because the earn-out payment timing is not linked to one of the permissible payout triggers, the Section 409A regulations expressly permit this type of arrangement if it meets certain requirements. For example, the earn-out for the equity compensation must be on the same schedule as earn-out payments to other shareholders, and the length of the earn-out cannot exceed five years. While there are times that the structure necessitated by the Section 409A regulations will work, there are other situations in which it is not desirable, and careful structuring must be considered to meet the needs of the parties to the deal and the Section 409A rules.

Another example of the challenges that Section 409A can raise in mergers and acquisitions is the limited ability under Section 409A to pay out or modify previous deferrals. It is often desirable for business purposes to make changes to compensation payment timing in connection with a corporate transaction. For example, the parties may want to delay payment of a retention bonus that is otherwise payable at closing.

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Or the parties may want to immediately pay out certain executives’ supplemental pension plan benefits at the time of closing. In both cases, Section 409A imposes significant limitations on these types of actions.

Making the Grade

As with any attempt to ace a test, preparation is critical when dealing with Section 409A. Companies should be aware of the types of issues that can arise and have a plan for tackling these issues at the front end of a negotiation or design of an arrangement, rather than as an afterthought when even minor changes are likely to cause problems. With the right game plan and a recognition that after 10 years, these complex tax rules are not likely to go away, every company can achieve a 409A+ on their corporate report card.