Executive Compensation

To Quote Section 409A: An NDCP by Any Other Name Is Still an NDCP

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When the topic of nonqualified deferred compensation plans (NDCPs) is raised, there are certain arrangements that immediately come to mind. Supplemental executive retirement plans (SERPs) in the style of defined benefit plans, straight deferral-only plans, Internal Revenue Code Section 401(k) “mirror plans,” and excess plans are among the vehicles that clearly must be parked in the Section

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409A compliance lot. Employers that offer such arrangements for their select group of top management and/or highly compensated employees have been inundated with information on this topic and most likely have already taken measures to address this requirement with a Section 409A-compliant plan document and operational procedures. It is crucial, however, to note that the Section 409A rules cast a very wide net when it comes to the definition of what constitutes an NDCP. Accordingly, employers need to regularly inventory and review their various compensation and benefits agreements in order to determine if any existing or new arrangements are structured in a manner that creates a Section 409A NDCP. This column highlights points to consider when conducting a Section 409A “to be or not to be” determination process.

THE GET-OUT-OF-SECTION 409A FREE EXEMPTIONS

Before beginning the inventory and review process, plan sponsors may be able to immediately wean out some arrangements from consideration if they qualify for a Section 409A exemption. The Section 409A rules specifically exempt some from coverage; these include but are not limited to the following:

- Qualified retirement plans under Section 401(a) or Section 401(k);
- Qualified annuity plans under Code Section 403(a);
- Tax-sheltered annuity arrangements under Code Section 403(b);
- Eligible deferred compensation plans under Code Section 457(b);
- Qualified governmental excess benefit arrangements under Code Section 415(m);
- Simplified Employee Pension (SEP), Salary Reduction SEP (SARSEP), and Savings Incentive Match Plan for Employees (SIMPLE) plans under Code Section 408;
- Plans involving deductible contributions to a Code Section 501(c)(18) trust;
- Certain foreign plans as described in Section 409A;
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- Certain welfare benefits (e.g., any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan);

- Any Archer Medical Savings Account as described in Code Section 220;

- Any health savings account (HSA) as described in Code Section 223;

- Any other medical reimbursement arrangement, including a health reimbursement arrangement (HRA), that satisfies the requirements of Code Section 105 and Section 106, such that the benefits or reimbursements provided are not includible in income.

THE WHO, WHAT, AND WHEN OF SECTION 409A COVERAGE

Who

Because Section 409A applies to all “service providers” (i.e., any entity that provides a service to another entity)\(^2\) and “service recipients” (i.e., any entity that receives a service from another entity),\(^3\) its regulatory reach is not limited to just arrangements between “employers” and “employees.” As a result, any entity that is a party to such an exchange (whether an individual or an organization) could be subject to Section 409A. Accordingly, organizations should not merely focus on compensation arrangements covering their executive employee groups. Arrangements covering rank-and-file employees, directors, partners, independent contractors, consultants, and even other entities potentially are subject to Section 409A.

What?

Unless an exemption (see above) or exception (see below) is available, Section 409A applies to any arrangement that provides for a “deferral” of compensation. Such deferral arrangements may be elective or nonelective. It could be a paragraph in an employment agreement for just one individual or a 50-page document for a group. Even if it is informal (e.g., communicated through an internal memo) or even oral (i.e., the classic “handshake agreement”), Section 409A could
come into play if a deferral is involved. The types of arrangements that may not ordinarily be associated with NDCPs but still should be reviewed for possible Section 409A implications include but are not limited to the following:

- Employment agreements;
- Bonus and other retention payments;
- Severance agreements;
- Stock options;
- Offer letters;
- Restricted stock units;
- Consulting agreements;
- Phantom stock;
- Change-in-control agreements;
- Certain reimbursement agreements;
- Director fee deferrals;
- Salary and bonus deferrals; and
- Section 457(f) “ineligible” plans.

When

The above-described “deferrals” of compensation will be deemed to have occurred for purposes of Section 409A if the terms of the plan and relevant facts and circumstances give participants a “legal and binding right” to taxable compensation that “is” or “may be” payable in a later year. The Section 409A rules make it clear that the only instance when there would be no “legal and binding right”—and thus no “deferral”—would be if the service recipient retained the discretion to unilaterally reduce or eliminate the amount of compensation to be paid. The rules specify that the same is not true (i.e., a deferral would occur) when the compensation may be reduced or eliminated by operation of the
objective terms of the plan, such as the application of a nondiscretionary, objective provision that creates a substantial risk of forfeiture.\textsuperscript{6} For example, assume an employer enters an agreement with a group of its employees in 2016 to pay such employees 10 percent of their compensation in 2020. If the agreement is structured so that the employer retains the unilateral right to reduce or eliminate the promised 10 percent payment, there is no Section 409A deferral. In contrast, assume that the agreement does not contain such right (\textit{i.e.}, the employer cannot reduce or revoke its promise to pay) but does require that the employees complete five years of service before they become vested in the promised benefit. In this case, even though the benefit would be forfeited if the participant terminates employment before completing five years of service, a Section 409A deferral will occur.

**EXCEPTIONS TO THE RULE**

If the discovery process described above uncovers potential Section 409A NDCPs, there may still be some hope for Section 409A not to apply to such arrangements; to be Section 409A-free, they must qualify for a specific exception. As described below, three of the most noteworthy exceptions are for arrangements that meet Section 409A\textcoquotation{'}s definition of \textquoteleft short-term deferrals,\textquoteright\ “severance pay,” or \textquoteleft reimbursement plans.” Arrangements that qualify for one of these exemptions will not be required to conform to the strict limitations on permissible payment dates under arrangements subject to Section 409A, including the limitations on changing a payment date.

**Short-Term Deferrals**

Ides of March is a Section 409A fateful day for employers\textcoquotation{'} bonus programs. Just as ignoring the seer\textcoquotation{'}s warning to \textquoteleft beware the Ides of March\textquoteright led to Julius Caesar\textcoquotation{'}s demise on that fateful March 15, employers with calendar fiscal years must be wary of this date. Otherwise, when they distribute their bonuses, they may find the payments falling victim to a similarly highly undesirable outcome—becoming subject to Section 409A. To qualify for the short-term deferral \textquoteleft get out of Section 409A free\textquoteright card, a payment must be made on or prior to the 15th day of the third month (\textit{i.e.}, March 15 for calendar fiscal years) following the end of the employees\textcoquotation{'} (or, if later, the employer\textcoquotation{'}s) taxable year in which the bonus amount is no longer subject to a \textquoteleft substantial risk of forfeiture\textquoteright (SROF).\textsuperscript{7}

Under Section 409A, amounts are generally subject to an SROF “if entitlement to the amount is conditioned on the performance
of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.” Accordingly, payment of the bonus is considered subject to an SROF if the employees only earn the right to payment once they have completed a specified number of years of service and/or met certain performance goals. Once such conditions are met, employees are considered to be “vested” in the benefit (i.e., entitled to the payment when it is made regardless of their employment status on the payment date). Employers sometimes add an extra condition by attaching a noncompete restriction under which employees forfeit the bonus if they terminate employment and enter employment with one of the employer’s competitors prior to the payment date. The inclusion of such a noncompete restriction, however, is not recognized by the Section 409A rules as sufficient to create a SROF. In addition, a forfeiture of a payment only upon a termination by the employer for “cause” is not recognized as a SROF.

The following two examples illustrate how these rules are applied for annual bonuses for employers with calendar fiscal years. Under the first scenario, the employer awards annual bonuses based on both the employer’s financials and the employees’ individual performances. Payment of the bonus is scheduled to be made in the first quarter of 2020, as soon as administratively practicable following the determination of the amounts. Participants must actually be employed with the employer on the payment date to receive the bonus. Because of this “active employment on payment date” requirement, the employees never become vested in the benefit until the actual payment date. Therefore, employers with this design need not be concerned about missing the March 15 payment deadline.

In contrast, assume the same facts as the previous example, except that in order to receive the bonus payment made in 2020, the employees must be employed on December 31, 2019, and must not violate a noncompete agreement prior to the payment being made. Because Section 409A does not recognize the noncompete condition, the vesting occurs in 2019. Consequently, in order to avoid Section 409A coverage, the bonus must be paid by no later than March 15, 2020, unless one of Section 409A’s limited late payment exceptions applies: (1) an unforeseen administrative delay, (2) the need to retain such funds because their disbursement would jeopardize the employer’s ability to continue as a going concern, or (3) the employer reasonably anticipating that its deduction of the bonus will be subject to the $1 million Internal Revenue Service (IRS) deduction limit (and the employer did not reasonably anticipate the application of Section 162[m] when the bonus award was originally made). Each of these three exemptions will only be considered valid if the employer promptly makes the
delayed bonus payment as soon as the applicable cause for the delay no longer exists.\textsuperscript{12}

What happens in the case of a bonus plan in which the amounts were vested in 2019, the March 15 payment deadline is missed, and none of the three exemptions are available? Does Section 409A coverage automatically spell doom in the form of noncompliance and the corresponding penalties? The good news is that it’s possible to structure bonus plans so that they comply with the Section 409A rules. So for any employer that currently has a bonus program and needs to meet the March 15 deadline (i.e., those programs that vest employees in the prior year), it’s crucial to examine their current bonus determinations and delivery processes. Does the employer have any intrinsic procedures (i.e., thereby eliminating the “unforeseen” exemption) that could cause the program to pay bonuses later than March 15 more than just on a one-time accidental basis? If the answer is “yes,” the employer should consult with its employee benefits specialist to review such bonus programs to make sure it is covered by a compliant Section 409A document, so that even if the payment date is missed and the “short-term deferral exemption” blown, the bonus payment does not violate Section 409A, thereby risking the costly consequences of such noncompliance. One does not need to be a seer to know that to do otherwise would tempt the fates of the Ides of March, which history has shown never to be sound policy whether for emperors, employers, or employees.

Another way to have the short-term deferral exception apply to annual bonuses is to require the employee to remain employed until January 1 of the year following the bonus year. In such cases, the bonus will comply with the short-term deferral exception if paid prior to March 15th of the calendar year following such January 1 vesting date. This would give the employer 14-1/2 months following the end of the bonus year to make the payment. For example, if an annual bonus for the 2019 calendar year requires the employee to be employed on January 1, 2020, to receive the bonus, then the short-term deferral exception will apply if the bonus is paid by March 15, 2021. This approach gives the employer plenty of time to deal with any unforeseen delays and still have a short-term deferral.

The short-term deferral exception may apply to other types of arrangements other than annual bonuses that may otherwise be subject to Section 409A, including certain severance payments, restricted stock units, phantom stock, and change-in-control agreements subject to the same rules described above, including that the payment be made by March 15th or other applicable date. To be eligible for short-term deferral treatment, severance must only be payable upon an involuntary separation from service, as described below.
Severance Pay: Separating It from Section 409A

Another exception applies to those arrangements that fall under the category of “severance pay plans,” provided they meet certain conditions. Under this exception, the arrangement will be considered Section 409A-free if the separation pay is made in connection with an involuntary separation from service or participation in a window program, provided the amounts to be paid meet the following two requirements:

1. They do not exceed the lesser of (1) two times the participant’s annual pay for the taxable year preceding the taxable year in which the separation from service occurs or (2) two times the Section 401(a)(17) limit for the year (e.g., $280,000 for 2019); and

2. They are paid in full no later than December 31 of the second year following separation from service.

If the amount of severance pay received by the service provider exceeds this limit, the good news is that the total exemption is not lost (i.e., the Section 409A exclusion will continue to apply to payments up to the limit). For example, assume a service provider is entitled to a payment of $300,000 in 2019 that otherwise qualifies for the exception except that it exceeds the $280,000 2019 limit; only $20,000 (i.e., the excess over the limit) will be subject to Section 409A. The individual’s right to the payment of $280,000 will not be subject to Section 409A and any of its limitations (e.g., the requirement that the payment be delayed for six months in the case of a specified employee), provided that such limited payment is otherwise required to be made—and is made—no later than the end of the second taxable year following the service provider’s taxable year in which the separation from service occurs.

When making this determination for purposes of:

- Applying the Section 401(a)(17) limit, the statutory limit applicable for the year the separation from service occurs must be used; and

- Determining the service provider’s annual rate of pay for the taxable year preceding the taxable year in which the separation from service occurs, an annual rate of pay based upon the service provider’s taxable year immediately preceding the service provider’s taxable year in which the separation from service occurs is used. Such rate is adjusted for any increase
during the year that was expected to continue indefinitely if the service provider had not separated from service.\textsuperscript{19}

As indicated above, another key element in meeting this exemption is that the separation from service be \textit{involuntary}. Section 409A provides that whether a separation from service is involuntary is determined based on all the facts and circumstances.\textsuperscript{20} For this purpose, any characterization of the separation from service as voluntary or involuntary by the service provider and the service recipient in the documentation relating to the separation from service is presumed rebuttable to properly characterize the nature of the separation from service.\textsuperscript{21} For example, if a separation from service is characterized as voluntary, the presumption may be rebutted by demonstrating that absent the voluntary separation from service, the service recipient would have terminated the service provider's services, and the service provider had knowledge that the service provider would be so terminated.

Even if the service provider resigns or quits, such separation from service may still qualify as involuntary for the purposes of meeting the exemption, provided certain conditions are met. In this case, the key determining factor is whether the facts and circumstances surrounding the service provider's departure constitute a “good reason” for leaving under Section 409A.\textsuperscript{22} In order to qualify, the inclusion of any good-reason condition in the separation pay plan or of the actions by the service recipient in connection with the satisfaction of a condition cannot merely be a device utilized for purposes of the avoidance of the requirements of Section 409A.\textsuperscript{23} In addition, such good-reason condition must require actions taken by the service recipient resulting in a material negative change in the employment relationship (e.g., a material negative change in the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received).\textsuperscript{24} Other factors that the IRS will review when determining whether a purported separation from service for good reason is the result of a bona fide good reason condition as opposed to a device constructed primarily for the avoidance Section 409A include the following:

- The extent to which the payments upon a separation from service for good reason are in the same amount and are made at the same time and in the same form as payments available upon an actual involuntary separation from service; and

- Whether the service provider is required to give the service recipient notice of the existence of the good-reason condition and a reasonable opportunity to remedy the condition.\textsuperscript{25}
Section 409A also provides a safe harbor under which a provision for a payment upon a voluntary separation from service for good reason will be treated for purposes of Section 409A as providing for a payment upon an actual involuntary separation from service. Those conditions include the following:

- The amount must be payable only if the service provider separates from service within a limited period of time not to exceed one year following the initial existence of the good reason condition.

- The amount, time, and form of payment upon a voluntary separation from service for good reason must be identical to the amount, time, and form of payment upon an involuntary separation from service.

- The service provider must be required to provide notice of the existence of the good-reason condition within a period not to exceed 90 days of its initial existence.

- The service recipient must be provided a period of at least 30 days following notice during which it may remedy the good reason condition.26

For these purposes, a good reason condition may consist of one or more of the following conditions arising without the consent of the service provider:

1. A material diminution in the service provider’s base compensation;

2. A material diminution in the service provider’s authority, duties, or responsibilities;

3. A material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider is required to report, including a requirement that a service provider report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar entity with respect to an entity other than a corporation);

4. A material diminution in the budget over which the service provider retains authority;
5. A material change in geographic location at which the service provider must perform the services; or

6. Any other action or inaction that constitutes a material breach of the terms of an applicable employment agreement.\(^27\)

**Reimbursement Plans**

Many service providers are covered under one or more plans under which their service recipients reimburse certain types of expenses (e.g., reasonable moving expenses or reasonable outplacement expenses directly related to a termination of the service provider's services) actually incurred by the service providers (including certain in-kind benefits provided to the service provider) following a separation from service. Reimbursement arrangements may be subject to, or exempt from, Section 409A depending upon a number of factors. Arrangements that are not taxable as compensation are generally exempt.\(^28\) For example, an arrangement to provide health coverage that is excludible from income under Section 105 generally would not be subject to Section 409A since such benefit is generally not taxable as compensation.

Arrangements that are taxable as compensation can be exempt from Section 409A in certain circumstances following a separation from service. One such circumstance is taxable reimbursements of medical expenses of the type that would be deductible under Section 213 for the period during which the service provider would be entitled (or would, but for such arrangement, be entitled) to continuation coverage under a group health plan of the service recipient under Section 4980B (the Consolidated Omnibus Budget Reconciliation Act) if the service provider elected such coverage and paid the applicable premiums.\(^29\) Another circumstance is taxable reimbursement arrangements meeting the following conditions:

- Such reimbursements are available only for certain expenses incurred following a separation from service (e.g., reasonable outplacement expenses and reasonable moving expenses); and

- The reimbursements are made, during a limited period (generally not after the second taxable year of the service provider following the separation from service, whether the separation from service is voluntary or involuntary).\(^30\)
This exception applies to the qualifying reimbursements available during the limited period of time, even if the plan extends beyond the limited period of time.

Plan sponsors would prefer that the limited period of time refer solely to the time the expense is incurred, and not the time the expense is reimbursed, to reflect the need for time to process the reimbursement request. Although Section 409A explicatively does not allow this, it does extend the period during which a service provider can receive a reimbursement payment by providing that such payments must be made not later than the end of the third year following the separation from service. This extension applies only to reimbursements of expenses incurred by the service provider. Where the service recipient provides in-kind benefits (as defined in the regulations), or the service recipient pays a third party to provide in-kind benefits, such benefits must be provided by the end of the second year following the separation from service.\textsuperscript{31} In addition, with respect to the treatment of rights to a reimbursement of any loss incurred due to a sale of a residence, Section 409A provides that, for this purpose, reasonable moving expenses include the reimbursement of an amount related to a loss incurred due to a sale of a primary residence, provided that the reimbursement does not exceed the loss actually incurred.\textsuperscript{32}

If post-termination reimbursements are not excluded from Section 409A under the provisions discussed above, such payments may be excluded from Section 409A if they do not exceed the dollar limit under Section 402(g)(1)(B) ($19,000 in 2019).\textsuperscript{33}

Reimbursement arrangements that are not exempt from Section 409A can still comply if they meet certain strict timing of payment rules under Section 409A.\textsuperscript{34}

\section*{CONCLUSION}

The truth will set you Section 409A-free—or at least make you Section 409A-compliant. Even though Section 409A has now been with us for over a decade, it continues to present challenges to “service recipients” and “service providers” alike. This column provides plan sponsors and participants with a summary of some of the most common issues they may face and alerts them of the need to be vigilant in monitoring their various compensation arrangements in order to determine if and when such arrangements must comply with Section 409A. The key is early detection so, if the arrangement is subject to Section 409A, it can be designed and operated in a manner that complies with the Section 409A rules. Consequently, employee benefit consultants and executive compensation counsel should be contacted prior to implementation to assist with this assessment.
NOTES

5. Id.
6. Id.
10. Id.
12. Id.
13. “The term separation pay plan means any plan that provides separation pay or, where a plan provides both amounts that are separation pay and that are not separation pay, that portion of the plan that provides separation pay.” Treas. Reg. § 1.409A-1(m).
14. “An involuntary separation from service means a separation from service due to the independent exercise of the unilateral authority of the service recipient to terminate the service provider’s services, other than due to the service provider’s implicit or explicit request, where the service provider was willing and able to continue performing services.” Treas. Reg. § 1.409A-1(n)(1).
15. “The term window program refers to a program established by a service recipient in connection with an impending separation from service to provide separation pay, where such program is made available by the service recipient for a limited period of time (no longer than 12 months) to service providers who separate from service during that period or to service providers who separate from service during that period under specified circumstances.” Treas. Reg. § 1.409A-1(b)(9)(vi).
19. Id.
21. Id.
23. Id.
24. Id.
25. Id.
26. *Id.*

27. *Id.*


34. *See* Treas. Reg. § 1.409A-3(i)(1)(iv)(A). For reimbursements or in-kind benefits to comply with § 409A the following conditions must generally be met: (1) the plan must provide for an objective, nondiscretionary definition of the expenses eligible for reimbursement or the in-kind benefits to be provided; (2) the plan must provide for a specific and objective period for which the arrangement will continue; (3) the plan must provide that payments made under the arrangement in one taxable year of the employee may not affect the payments made in any other taxable year; (4) there can be no right to any other benefit or any payment in lieu of the benefit provided under the reimbursement or in-kind benefit arrangement; and (5) reimbursement must be made not later than the end of the year following the year in which the expense was incurred.