Section 409A Audits
Observations and Workplan

American Benefits Council
Executive Compensation Briefing

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Agenda

- High-Level Review of Section 409A
- Update on IRS Audit Activity and 409A Guidance
  - Introducing: The REAL Audit Enemy (It's Not the IRS)
- Preparing for an Audit
  - Preliminary Questions
  - Building the Catalog
  - Zoological Taxonomy
  - Common Pressure Points
  - Handling Risk and Errors
- Q&A

High Level Review of Section 409A

Review of Section 409A

- Section 409A is intended to force taxpayers to say exactly “when” future compensation will be paid
  - Gov’t felt ability to manipulate timing was abusive
- Promise today-----------→ Pay later: When?
  - Calendar year
  - Other events – defined in exhaustive detail
    - “Change in Control”
    - “Separation from Service”
    - “Unforeseeable Emergency”
    - “Disability”
    - Death – (not defined)

Review of Section 409A (cont.)

- Section 409A applies to “deferred compensation”
- Scope of deferred compensation is very broad
  - Potentially any arrangement that promises compensation in a future year
- For most companies, Section 409A issues arise in
    - Employment agreements
    - Severance agreements
    - Equity and long-term incentive plans (bonus)
    - Nonqualified deferred compensation (top hat) plans

If Section 409A Applies…

- May/must be paid only upon permissible payment triggers
  - Specified date
  - Death
  - “Disability”
  - “Unforeseeable Emergency”
  - “Change in Control Event”
    - Note: IPO doesn’t qualify
  - “Separation from Service”
    - Thresholds to prevent manipulation
    - 6-month wait for top employees of public companies where separation from service is the trigger

If Section 409A Applies… (cont.)

- Arrangement must state the time (trigger) and form of payment
  - If participant may designate amount, time or form of benefit, the election must be made by certain deadlines
    - Example: If a participant may elect to defer Year 2 salary, the election must be made by December 31 of Year 1 and must state the time and form of payment (e.g., lump sum in Year 15)
- Once form and trigger are identified, the compensation generally cannot be accelerated or further deferred

If Section 409A is Violated…

- If an arrangement violates Section 409A (in form or operation):
  - Participant, <u>not</u> the Company, is subject to
    - Immediate income tax to the extent vested
    - 20% penalty plus other underpayment penalties
  - Company is subject to
    - Potential reporting/withholding failures
    - Egg on face?
- Some correction methods are available
  - Discussed later…

Exemptions from Section 409A

- Qualified Plans
- Certain stock rights (options/stock appreciation rights)
  - No discount; common stock of service recipient or entity up the chain; no deferral features
- Certain severance pay
  - Meets conditions and up to certain limits (2x/2yr)
- "Short-Term Deferrals"
  - Pay-when-vest arrangements

Update on IRS Audit Activity and 409A Guidance

And Introducing…
The REAL Audit Enemy
(It's Not The IRS)

409A Audit Activity and Guidance

- IRS Audit and Investigation History
  - Starting in 2009, IRS issued Information Document Requests (IDRs) that were broad and detailed
    - Seemingly, went nowhere
  - In 2014, IRS announces limited audit of fewer than 50 large employers already under employment tax audit
    - Part of a Compliance Initiative Project (CIP) to find general areas of non-compliance
    - Scope focused on traditional nonqualified deferred compensation retirement plans
      - Stayed in SHALLOW waters

409A Audit Activity and Guidance (continued)

- In June 2015, IRS updates Audit Techniques for Nonqualified Deferred Compensation
  - Arguably gives short shrift to Section 409A
  - Focuses on tax issues
    - Income recognition
    - Deduction timing
    - Employment taxes
  - Stays within traditional nonqualified deferred compensation mindset

409A Audit Activity and Guidance (continued)

- Summer of 2015, IRS issues two General Counsel Memoranda (GCMs)
  - One GCM regarding stock option questions related to over-the-counter employer: grant date, exercise price, and income inclusion
  - Other GCM opining on “correction” of unvested amounts that vest later in same year
    - More on this later
- As we sit here today
  - Income inclusion regulations still not finalized
  - Awaiting Section 457 regulations, expected to include additional 409A guidance

Introducing the Real Audit Enemy

Your counterpart in an M&A Transaction!

As part of due diligence, buyer/lender will do a full cavity search

- Section 409A in the broadest possible scope
  - Every compensatory arrangement is subject to scrutiny
- A Day of Reckoning
  - Issues more black or white
  - Risks quantified and negotiated

Preparing for a 409A Audit

Preparing for a 409A Audit

- Preliminary Questions
- Building the Catalog
- Zoological Taxonomy
- Common Pressure Points
- Handling Risk and Errors

Preliminary Questions

- Will we engage legal counsel?
- How far back in time will we go?
- Do we have international implications?
- What are we prepared to do?
  - Use correction guidance (if available) and include attachments to tax returns?
  - Indemnify for penalties?
  - Materially increase compensation in connection with extended vesting?
  - Amend or adopt arrangements?
    - Internal procedures
  - Risk tolerance?

Building the Catalog

- Essential to collect EVERY compensatory arrangement
  - Look everywhere, even under the couch cushions
- Examples
  - Employment Agreements and Offer Letters
  - Severance Agreements and Severance Plans
  - Change in Control Agreements
  - Bonus Plans (short-term and long-term)
  - Equity and equity-based arrangements
  - Nonqualified Retirement Plans (traditional "top hat")
- Other documents too
  - Release agreements
  - Indemnity agreements
  - List of Specified Employees?
  - Section 409A Policies and Procedures Document?

Zoological Taxonomy

- Helpful to classify these arrangements

- Exempt Animals, including
  - Short-term deferrals (pay-when-vest)
  - Certain stock rights
  - Certain separation pay
  - Limited COBRA

- 409A Animals (or Potentially a 409A Animal)
  - Plan types, including:
    - Elective account
    - Non-elective account
    - Non-account
    - Stock rights
    - Separation pay
    - In-kind benefits/reimbursements

Zoological Taxonomy (cont.)

- Practical Note: Some companies will be more detailed than others documenting compliance
  - <u>Lax example</u>: "Provided employment agreement to [attorney/expert] and asked if it is okay from a 409A perspective. Yes, said she."
  - <u>Fastidious example</u>: Provided employment agreement to [attorney/expert] and received the following:
    - Confirmation no amendments or other documents modify agreement terms
    - Section 4(a) provides salary – exempt as short-term deferral (requiring continued service)
    - Section 4(b) provides annual bonus – exempt as short-term deferral
      - Requires continued service through December 31, payment date before next March 15
    - Section 4(d) provides stock option award – explicitly governed by equity plan and award documents (analysis provided elsewhere)
    - Section 6 provides severance of $X, payable in 12 monthly installments–all exempt by stacking short-term deferral and separation pay exemptions
      - Payable only upon "involuntary termination"
        - Definition of Good Reason tracks 409A safe harbor, but also includes reduction in bonus; notice and cure period required
      - Payment commences on Day 30 after termination, subject to having already provided effective release
      - Payment identified as "separate" payments for purposes of Section 409A
    - And so on…

Pressure Points: Short-Term Deferrals

Promise to future payment ------> [Vest and Pay]

- When does it vest? ("Substantial Risk of Forfeiture")
  - Continued Service or event related to the purpose of the compensation
  - Risk of forfeiture must be substantial
  - Vest upon Retirement?

- When does it pay?
  - Must be paid no later than 2.5 months after end of employee's or employer's tax year of vesting
  - Document can't identify date or event that could occur after that date

- What does document say?
  - If condition (e.g., once we have financial statements):
    - Do we have a March 15 deadline (still exempt)
    - Does it identify a single calendar year? (not exempt, but compliant)
  - If silent (i.e., no indication when money is paid)
    - In operation, when is it paid?
    - Risk a dangling deferral

- In operation, when is the compensation paid? Still a short-term deferral?

Pressure Points: Stock Rights

Stock options and stock appreciation rights

- If exempt, can be exercised at any time up to expiration
- If not exempt, must be exercised upon permissible 409A trigger

- To qualify as exempt
  - Stock right must relate to "service recipient stock" (common stock of service recipient or entity up the chain)
  - Exercise price can be no less than "Fair Market Value"
  - Stock right can't contain a "deferral feature" (e.g., right to delay taxation beyond exercise or expiration)

Also remember:

- Restricted stock generally not subject to 409A
- Phantom equity typically subject to 409A or exempt as short-term deferral
- Equity of Partnerships/LLCs treated analogously

Pressure Points: Stock Rights (cont.)

- Service Recipient Stock
  - Identify entity issuing the option and service recipient
  - Confirm equity instrument qualifies

- Fair Market Value (FMV)
  - Public company – follow plan documents
  - Private company – how was FMV established?

- No Deferral Features
  - Extensions granted, perhaps as part of separation settlement?
  - Repurchase rights – capital transaction or compensatory?

Pressure Points: Separation Pay

If not exempt, severance packages must pay upon a 409A "separation from service" and may need to impose six-month wait.

Separation pay most commonly exempt under one or more "stackable" exemptions, including

- short-term deferral (pay-when-vest)
- "two-times" separation pay

Those exemptions available only if separation pay contingent upon "involuntary" termination (i.e., firing or robust "Good Reason")

Pressure Points: Separation Pay (cont.)

- Is the qualifying termination "involuntary"?
  - Watch for Retirement or soft good reason thresholds
  - Is severance paid upon death or disability?
- Don't step in Release trap
- Does the document identify payments as "separate"?
- In practice, have there been departures from the agreement?
  - Increasing payments
  - Accelerating or delaying payments

Pressure Points: Nonqualified Retirement Plan and Other 409A Animals

- Payment triggers properly defined?
- Deferral election forms
  - Comply with general deferral timing rule?
  - Comply with special deferral timing rules (initial eligibility, performance based compensation, etc.)?
  - Properly identify amounts to be deferred?
- Application of six-month delay for "Specified Employees"
  - How identified or designed to comply?
- Maintain a catch-all 409A policy?
- Does operation follow plan terms?

Handling Risks and Errors

- If violation (form or operation) is clear and cannot be corrected, obey the law!
  - But remember that overripe errors (closed tax years) are no longer violations
    - <u>Example</u>: Distribution due in 2007 was never made. Violation occurred in 2007 and can be paid now without 409A problem. Normal income tax applies.
  - Indemnify?

- Often, unclear whether an arrangement violates Section 409A
  - Compile all compliance arguments
  - Consider: What if we're wrong?

Handling Risks and Errors (cont.)

- Clear error, but correctible?
  - Operational errors (Notices 2008-113, 2010-6 & 2010-80)
  - Document errors (Notices 2010-6 & 2010-80)
- Many corrections require one-page notice to be attached to both employee's <u>and</u> company's next tax return
  - Increase audit risk?
  - Need good communication among internal groups (HR, Tax, etc.)
- Some companies more hesitant than others to use correction guidance
  - Look to argue correction guidance not necessary
  - Even concede violation in some cases

Handling Risks and Errors (cont.)

- Immature = Not yet vested
  - May self-correct while unvested
    - Operational or document problems
    - Can't use if vests later that year (2015 GCM)
  - No need to use formal correction guidance or attach notices
  - Can't abuse it…
    - Only used to correct inadvertent errors
    - No pattern of using rule to abuse 409A

- It would be so great if this didn't vest this year…
  - If would vest upon change in control, can add new condition to extend vesting
  - Otherwise, need materially greater amount

Questions?

- Call:
  - Michael Falk
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- Buy my book!
  - *Practical Guide to Code Section 409A* (CCH, 2012)
    - Holidays will be here before you know it!

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