Section 409A Audits
Observations and Workplan

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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
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, not 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)
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
Practical Note: Some companies will be more detailed than others documenting compliance

- **Lax example**: “Provided employment agreement to [attorney/expert] and asked if it is okay from a 409A perspective. Yes, said she.”

- **Fastidious example**: 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…
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
    - Example: 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?
Clear error, but correctible?

Many corrections require one-page notice to be attached to both employee’s and 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:
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- Buy my book!
    - Holidays will be here before you know it!
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