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Practitioner's View

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Section 409A Creates More Work for Lawyers and Roadblocks for Employers, Attorney Says

In an e-mail interview, Ed Bintz discusses how Section 409A has changed executive compensation practice and the challenges it presents in certain situations in which a client's business needs and the 409A rules diverge.

BBNA: What are the major changes you have seen in your practice post-409A?

Bintz: For me, there have been a couple of major changes. Section 409A has grown the executive compensation practice area so I definitely spend more of my time working on executive compensation projects. In my case, the growth has come from a number of sources, but two in particular stand out.

First, I spend a lot more time providing advice with respect to employment and severance agreements. Prior to Section 409A's enactment, a corporate or employment lawyer could generally draft an employment or severance agreement with some relatively light tax assistance on Section 280G provisions. Now, because severance benefits, release delivery requirements and a range of other employment agreement provisions have Section 409A aspects, I spend quite a bit of time in the area.

The second significant area where Section 409A has created quite a bit of additional work is mergers and acquisitions. Section 409A compliance issues come up with some regularity during due diligence and can require quite a bit of follow-up work. Also, how target company incentive awards and change in control severance benefits are handled has become more complicated and requires more time and attention.

From an overall perspective, the general complexity of the issues we deal with has grown as a result of Section 409A. More often than is ideal, Section 409A issues land in a gray area and sometimes we have to advise a client that even though what they want to do may make perfect sense from a business perspective and is not tax motivated, it can't be implemented without violating Section 409A. Usually we can get the client close to its objective, but sometimes not as close as all would like.

BBNA: Do you have any examples of situations where Section 409A was a roadblock to a business-driven compensation arrangement that had no tax motivation?

Bintz: A recent situation that comes to mind involved an early-stage technology company that was hiring a new executive and had put together a term sheet for the executive's employment. Part of the negotiated terms of employment were that 50 percent of the executive's base salary would deferred and paid at the earlier of the second anniversary of the date of hire or the company's closing of a capital raise in excess of a specified dollar amount. Because the executive would have a vested right to the deferred salary, and a capital raising transaction isn't a permissible payment event under Section

409A, the proposed arrangement was not Section 409A compliant. We were able to put together a satisfactory alternative structure, but the parties involved were incredulous as to why their original proposed agreement wouldn't be permissible.

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A second situation that comes to mind involved a company whose principal remaining assets were a number of pending litigation damage claims. The company wanted to grant to its remaining executives a vested interest in a percentage of the recoveries that would be paid to the executives as the cases were settled or damages were awarded as the result of favorable judgments. Because the settlement of the litigation or a favorable judgment wouldn't be a permissible Section 409A payment event, the proposed structure wasn't workable from a Section 409A perspective, even though it was driven by legitimate business goals and was not motivated by tax considerations.

BBNA: What has been happening in the area of IRS enforcement of Section 409A?

Bintz: So far, there has been very little in the way of Section 409A enforcement by the IRS. The IRS did, however, announce earlier this year a Section 409A audit initiative that involves less than 50 employers. The IRS has said that the focus of the audits would be limited to initial deferral elections, subsequent deferral elections and payouts, and would be limited to the top 10 most highly compensated employees. The focus of the audits is on very basic issues, so it may well be the case that any broader program would have a similar focus on the basics of Section 409A compliance.

BBNA: Are there any areas where you tend to see more in the way of noncompliance?

Bintz: The areas where I've seen relatively more noncompliance are severance arrangements and restricted stock units. With severance arrangements, the noncompliance tends to occur where the severance isn't designed to fall within an exception to Section 409A. Where that's the case, the most common problems have been failure to include the six-month delay rule and release delivery requirements that impermissibly allow an executive to potentially affect the year of payment of severance depending on when he or she delivers the release.

With restricted stock units, the problem that I've seen surprisingly often occurs where the agreement provides for vesting upon retirement and the executive either has already reached retirement age at the time of grant or will at a point early enough in the award period that the RSUs don't qualify under the short-term deferral rule. What seems to be missed with RSU retirement vesting provisions is that the executive is vested at the time he or she attains retirement age, regardless of whether the executive actually retires. Where the short-term deferral rule doesn't apply, violations can arise if payment of the RSUs is accelerated upon the occurrence of a change in control and the change in control definition doesn't comply with the Section 409A regulations or, for public companies, if the agreement doesn't include a six-month delay provision. Fortunately, both problems often can be corrected without penalty.

BBNA: What impact has Section 409A had in the area of mergers and acquisitions?

Bintz: It's had a significant impact in a number of ways. As I mentioned earlier, during due diligence reviews of target company compensation and benefit arrangements, potential Section 409A problems are found with some frequency. Because of Section 409A's complexity, the analysis as to whether there is in fact a problem and, if so, how it's best handled can itself be a complicated and time-consuming process. Among the potential solutions is to take advantage of the IRS's self-correction program, which for many types of violations requires the payment of a portion of the Section 409A penalty taxes.

Another area where Section 409A comes into play in an important way in the M&A area is dealing with change in control severance agreements. One issue that arises with some regularity is where a target executive who the buyer wants to retain has the right terminate employment and trigger his or her severance immediately after closing. Because the executive generally doesn't want to pass up the substantial pay-out he or she would receive by terminating, a relatively common solution is to pay out the severance at the time of closing even though the executive remains employed. If the severance is designed to be exempt from Section 409A, it generally can be paid out even though the executive doesn't terminate employment. But if the severance isn't exempt, dealing with the situation is more complicated. One potential solution that can allow payment of the severance without a termination of employment is to rely on the change in control plan termination rule in the Section 409A regulations. This solution, though, is not without its challenges, including making sure that all severance arrangements are identified and terminated.

The handling of equity-based compensation awards in mergers or acquisitions also can involve Section 409A complexities. One issue that comes up with some frequency is whether it's permissible under Section 409A to pay out the spread on an unvested option after closing of a transaction on a schedule that tracks when the option would have vested. Treasury and IRS officials have informally indicated that doing so is permissible, but guidance has yet to be issued.

BBNA: For employers generally, what are the biggest obstacles to compliance?

Bintz: I think the biggest obstacle is the complexity and broad reach of Section 409A. Even lawyers whose practice includes a focus on Section 409A struggle with Section 409A's complexities. Even where substantial resources are devoted to compliance, the complexity raises the risk of technical errors to, I think, an unreasonable level. This problem is heightened for mid-size and smaller employers who generally have fewer resources available to devote to Section 409A compliance.

BBNA: Practitioners have now had many years of experience with final and proposed regulations under 409A. Are there particular issues that need further guidance or clarification?

Bintz: The IRS's self-correction programs under IRS Notices 2008-113 and 2010-6 are very dense and difficult to work through. The IRS's 2014-2015 Priority Guidance Plan includes updating Section 409A correction plan guidance, which Treasury has informally indicated will include combining the programs, making them clearer and simpler, and possibly expanding the types of violations that are covered. All of this would be welcome. Guidance on the treatment of equity compensation in change of control transaction would also be quite helpful.

By Mary Hughes

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