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Prompt Action May Prevent Section 409A Violations in Employment Agreements

Section 409A of the Internal Revenue Code imposes significant tax penalties on employees who participate in nonqualified deferred compensation plans that fail to meet certain requirements, either because the plan does not have the required provisions or because the plan is not operated according to the applicable rules. Section 409A generally requires, among other things, that payment dates for deferred compensation are fixed in advance, and payments are not subject to discretionary acceleration. When a plan violates Section 409A, employees who participate in the plan are hit with accelerated income tax liabilities and a 20% additional income tax on top of their usual income tax liability, plus, in some cases, an additional interest-like tax. Section 409A reaches not only traditional nonqualified plans, such as supplemental executive retirement plans (SERPs) and excess benefit plans, but can also extend to employment agreements (including severance and release provisions), bonus arrangements and stock-based compensation plans.

The long arm of Section 409A is illustrated by a recently-released Internal Revenue Service internal memorandum (Chief Counsel Advice 201518013 (April 14, 2015)). The memorandum concerns a fairly garden-variety retention bonus agreement between an executive and his employer which is subject to the requirements of Section 409A. After the agreement is entered into, but before the executive's right to the bonus vests, the employer realizes that the agreement contains provisions that violate Section 409A in that the employer is given discretion to accelerate payment dates. During the calendar year of vesting, but before the actual vesting date, the employer amends the agreement to delete the defective provisions. The executive thereafter vests, and the bonus is paid out in an otherwise Section 409A-compliant manner.

The IRS concludes in the memorandum that the employer's attempt to correct the Section 409A violation in the retention bonus agreement by amending the agreement during the calendar year of the vesting date does not prevent a Section 409A violation. However, the IRS memorandum acknowledges that a Section 409A violation can potentially be corrected if corrective action is taken *prior to* the calendar year in which the deferred compensation vests. Had the employer acted sooner and amended the agreement to delete the "wrong" language before the year of vesting, Section 409A penalties could have been avoided. For example, defective severance provisions (e.g., an employment agreement that allows the employee to choose between receiving severance in a lump-sum or in installments) should be correctible if amended before the calendar year in which the employee's employment is terminated.

The IRS memorandum shows that nonqualified deferred compensation plans must comply with Section 409A both in form (i.e., the plan must not have the "wrong" language) *and* in operation. Accordingly:

- employers should analyze each of their compensation and benefit plans and agreements (other than tax-qualified plans, such as 401(k) plans) to see if they are potentially subject to Section 409A;
- those that are potentially subject to Section 409A should be examined to determine whether the language of the relevant document complies with or is exempt from Section 409A;
- if a document has the "wrong" language, it should be amended, if possible, to correct the language before the calendar year in which the right to compensation vests; and
- nonqualified deferred compensation plans with the "right" language must be operated in compliance with their terms.

Our lawyers have broad and deep expertise and experience with all aspects of executive compensation, including Section 409A, and would be pleased to help you ensure that your executive compensation arrangements comply with the increasingly complex tax and other legal requirements governing this arena.

If you would like more information, please contact Mark Hamilton, Esq. at 914.948.1556 ext. 8038 or by email at mhamilton@dmlawyers.com