



Understanding Section 409A Nonqualified Deferred Compensation Plans

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Equity compensation, such as stock options or restricted stock grants, is an effective way for emerging businesses to compensate personnel, retain talent, and incentivize the achievement of performance measures. However, many forms of equity compensation can be treated as “deferred compensation arrangements” and must comply with a complicated section of the Internal Revenue Code – Section 409A – with grave tax consequences imposed on the employee for non-compliance. This *Quick Study* provides a general overview of Section 409A and how it affects certain stock-based compensation arrangements.

When To Apply Section 409A

Internal Revenue Code Section 409A generally applies to a legally enforceable right to taxable compensation for services that workers earn in one tax year, but that is not included in income during that year or within the first two and one-half months of the next tax year. This is referred to as “nonqualified deferred compensation.” This is different from deferred compensation which results from contributions to qualified retirement plans, such as a 401(k), 403(b) or 457(b) plan. If a nonqualified deferred compensation arrangement does not meet the requirements of Section 409A, the compensation will be included in taxable income when vested – even if there is no payment event triggered at such time – and will be subject to certain additional taxes, including a 20 percent additional federal income tax. In contrast, if Section 409A is satisfied, the nonqualified deferred compensation is not taxed until received by the employee upon a permissible payment event. Section 409A’s payment timing restrictions and tax consequences for employees for noncompliance should strongly influence how businesses structure nonqualified deferred compensation plans, especially ones that involve stock options or restricted stock grants.

Section 409A Compliance Requirements

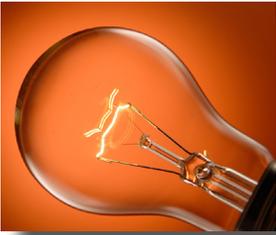
Any compensation subject to Section 409A may only be paid upon the occurrence of a payment event that is specified in Section 409A and the Treasury Regulations thereunder. The payment event must be specified either in the nonqualified deferred compensation plan when it was created or in a deferral election that is timely made by an employee. Section 409A triggering payment events are:

- The employee’s disability, death, or separation from the business;
- A change in control of the business;
- The occurrence of an unforeseeable emergency; or
- At a time originally specified under the nonqualified deferred compensation plan.

Effect of Section 409A Compliance Failure

Failure to comply with the requirements of Section 409A can have negative tax consequences for the affected employees. Section 409A violations fall into one of two categories: (1) documentary violations arise when a nonqualified deferred compensation plan includes provisions that are inconsistent with the Section 409A rules (i.e. the operative document was drafted incorrectly and does not comply with Section 409A); and (2) operational violations occur when there is a payment from a nonqualified deferred compensation plan that violates the terms of the plan, and accordingly, the Section 409A rules. Section 409A noncompliance results in the following consequences:

- All compensation previously deferred is included in the recipient’s (employee’s) gross income for the purposes of income taxation.
- The previously deferred compensation is also subject to an additional 20 percent federal income tax.



- Note, some states have adopted a similar tax penalty (e.g., California imposes an additional 5 percent penalty, Cal. Rev. & Tax Code Section 17508.2).
- The recipient must also pay interest based on the underpayment that would have applied if the deferred compensation had been deemed income in the year first deferred. The interest is the federal underpayment interest rate (under Section 6621) plus an additional 1 percent.

Stock Compensation Arrangements Affected By Section 409A

The Section 409A Treasury Regulations exempt certain types of nonqualified deferred compensation from compliance with Section 409A. For example, grants of restricted stock typically do not have to comply with Section 409A. In addition, the Treasury Regulations exempt nonqualified deferred compensation that comes in the form of plain vanilla stock options that have an exercise price equal to or greater than the fair market value (FMV) of the underlying stock at the time the option was granted. Section 409A does, however, apply to restricted stock units (if the underlying shares are not issued by two and one-half months after the tax year in which the vesting event occurs (generally this is March 15)) and discounted stock options (i.e., an option with an exercise price of less than the FMV of the underlying stock at the time it was granted). In the case of a discounted option, in order to comply with Section 409A, the option should provide for an exercise date that is a triggering payment event specified in both the applicable nonqualified deferred compensation plan and Section 409A.

The Importance of Section 409A Valuations To Stock Options

The determination of the FMV of stock is of particular importance to the issuance of stock options, as the valuation will determine whether the option's exercise price has been discounted as of the date of grant and therefore must comply with Section 409A, or whether the option is exempt from the requirements of Section 409A. The determination of FMV is different for publicly traded companies and privately held companies, as follows:

- For publicly traded companies, valuations are fairly straightforward: the FMV of the stock is its market price when the option is granted.
- For privately held companies, determining the FMV of stock can be a tricky matter because there is no efficient market for gauging the value of the stock. Pursuant to Section 409A and the Treasury Regulations issued thereunder, there are a few valuation methods available for determining the FMV of a private company's stock. The safest (and most expensive) method entails hiring a qualified independent appraiser to perform the valuation of the company.

Although expensive, the use of a qualified independent appraiser is a paramount consideration for startups and emerging businesses because venture capital firms are less likely to reject a prior Section 409A valuation performed by such an appraiser when the firm is considering an investment in the business. Some venture capital firms even limit their investments to companies that have engaged a preapproved Section 409A appraiser. The rejection of a prior Section 409A valuation can delay the influx of capital and, depending on how fickle the venture capital firm is, jeopardize an entire investment opportunity.

Conclusion

Companies should be mindful of Section 409A's extensive requirements at the earliest stages and throughout the life of the enterprise. Section 409A enforcement efforts have begun (through employment tax audits) and are expected to increase over the coming years. While Section 409A and the Treasury Regulations thereunder are complicated and lengthy, it is not impossible to comply. Careful planning and drafting with the assistance of experienced legal counsel should ensure that emerging businesses steer clear of Section 409A problems, leaving their executives with the potential to receive a compensatory reward, instead of a potential tax burden.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors:

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