



## **The Burden of IRS Code Section 409A**

Part I of the series “What Private Firms Should Know about Deferred Compensation”

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On January 1, 2005 the new IRS Tax Code Section 409A (“the Code”) became effective<sup>1</sup>. The Code was originally thought to impact only large, publicly traded firms, but following recent guidance it has been determined that the burden of compliance falls squarely on all firms that issue non-qualified deferred compensation regardless of size.

### ***What is IRS Code Section 409A?***

Section 409A is a broad reaching regulation that impacts all forms of non-qualified deferred compensation- e.g. options, SARRS, salary deferrals, etc. - even those that have generally not been thought of as deferred compensation. As mentioned above, the code became effective in the beginning of 2005 as part of the American Jobs Creation Act. Due to public outcry, the IRS has issued guidance on several occasions over the past year in an attempt to address specific concerns. This article will help to decipher the code as well as the subsequent guidance that has followed with the goal being to produce a clear and concise resource on the topic.

### ***What is its impact?***

IRS Code Section 409A impacts all forms of non-qualified deferred compensation with severe penalties for plans that are found to be “defective.” All amounts deferred under “defective” plans will generally be recognized as immediate income to the employee or participant, and are subject to an additional 20% (plus interest at the underpayment rate plus 1%) penalty tax. In addition, the code not only impacts all amounts deferred under the defective plan, but it also impacts all other amounts deferred under all other plans for the affected employee in the taxable year!

Basically, this means that the employee or participant will lose the tax benefits of all non-qualified deferred compensation plans in a given taxable year if one of their plans is found to be defective- e.g. the employee cannot defer tax liability into a future period. They will be subject to an additional 20% penalty tax, and will be required to pay interest (plus 1%) for the amount of time that they owed back-taxes on the ineligible amounts.

### ***What plans are subject to 409A?***

The list of plans affected by Section 409A is extensive, including more than just traditional stock option plans, with items that generally have not been considered deferred compensation.

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<sup>1</sup> Since the original date of this article the date of compliance has been pushed to January 1, 2008.

The list of affected plans includes:

- Elective salary deferral arrangements (*e.g.*, top-hat plans, deferred compensation plans)
- Mirror/401(k) "wrap" plans
- Excess benefit plans
- Elective annual and long-term bonus deferral arrangements (unless paid within 2-1/2 months after the close of the calendar year in which service was performed or the close of the employer's fiscal year in which the right to the compensation is no longer subject to a substantial risk of forfeiture);
- Code Section 457(f) arrangements
  - Under these plans of tax-exempt and governmental employers, benefits are taxable to participants immediately on an unsecured promise to pay benefits at a future time, unless that benefit is subject to a substantial risk of forfeiture.
  - Pre-409A, participants in 457(f) plans could avoid current taxation by maintaining a substantial risk of forfeiture (within the meaning of Section 457(f)) beyond the date their benefits vested. This was often accomplished with a rolling risk of forfeiture—a common practice used to defer vesting until termination of employment, or a non-compete clause—commonly used to defer recognition of income following termination of employment. Neither of these techniques, however, constitutes a “substantial risk of forfeiture” under Section 409A (which may cast a shadow of doubt over the permissibility of these techniques for 457(f) purposes). Nor do these techniques comply with the time and form of distribution and anti-acceleration provisions of Section 409A. Accordingly, if a Section 457(f) plan sponsor would like to allow participants the ability to defer payment beyond the time benefits vest, for 409A purposes, it must permit participants the ability to make an election as to when the benefits will be distributed from the plan prior to the time a deferral is made and in accordance with the election and distribution rules of 409A.
- Non-qualified employee stock options (ESOPs)<sup>2</sup>
- Phantom stock, restricted stock units, performance units and change in control plans to the extent they provide a deferral of compensation
- SERPs (State Earnings Related Pension)
- Individual employment contracts or severance arrangements with a deferral feature
- Any other arrangement that includes a deferral of income feature.

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<sup>2</sup> Generally, traditional non-qualified ESOPs are exempt from 409A, but several requirements must be met to prevent immediate taxation – with the primary feature being a strike price equal to the stock price on the day of grant.

Although this list is extensive, making it difficult to go into detail on each plan, there are several fundamental rules that firms can follow. Of course, many plans may require individual consideration by an experienced third party to ensure compliance.

### ***Fundamental Rules***

There are several fundamental rules that all non-qualified deferred compensation plans must follow in order to comply with the code. This is not a holistic list and even plans that do not feature these characteristics may still fall under the code for other reasons. Some additional requirements on specific plans will be addressed in more detail to follow, but some plans may once again require additional examination by a qualified party to ensure compliance.

### ***Acceleration Features***

Generally, plans that feature any form of acceleration in the pay-out of funds (barring death, unforeseen emergency, death, disability, or separation of service) are prohibited and will result in the immediate recognition of amounts deferred as income.

### ***Additional Deferral Features***

Plans that have additional deferral features will be subject to Section 409A and amounts deferred will be treated as immediate income. Deferral features allow for amounts that have initially been deferred to be pushed out even further into the future, e.g. restricted stock that has vested and is no longer subject to “substantial” risk of forfeiture but is still not awarded and subsequently recognized as income. Under Section 409A amounts that are deferred after a “short-term” deferral period must be awarded within 2 ½ months after the close of the calendar year in which the services were performed or the close of the employer taxable year in which the amounts are no longer subject to “substantial” risk of forfeiture. Plans such as a simple salary deferral for one year fit the bill as a short-term deferral.

### ***Deferral elections***

Most deferred compensation plans have periods over which employees or participants are allowed to make contribution or deferral elections under Section 409A. These election periods vary with the plan type and its characteristics. In general, elections for plans that are not subject to any performance based criteria must be made before the beginning of the taxable year in which services will be performed. However, it is possible to make elections on plans that are dependent upon some performance criteria up to 6-months before the end of the performance period. Again, many plans will have small differences in allowable election periods, so speaking with a qualified party may be helpful.

Basically, plans should specify how long amounts are to be deferred, how they are subject to “substantial” risk of forfeiture (if this applies), under what terms and conditions they are to be paid out (i.e. payment upon a specific date or event), and the pay out

should occur within 2 1/2 months of the terms or conditions having been met and the risk of forfeiture having lapsed. In addition, plan elections should be made either before the beginning of the taxable year in which the services will be performed (non-performance plans) or within 6-month of the end of the performance period (performance plans).

### *Impact on common equity instruments*

This section focuses on the impact that IRS Code Section 409A has upon various forms of equity based compensation (e.g. stock options, restricted stock, etc.) and there similarly valued cousins (e.g. phantom stock, SARs, etc.)

### *Employee stock options*

Non-qualified employee stock options (ESOPs) are the most common form of deferred compensation used today. Generally, these plans are exempt from the code if the strike price of the grant is equal to the stock price on the day of grant. This process is easy for publicly traded companies who simply reach to the market for the strike price, but this can prove to be a daunting task for privately held companies who do not have access to a publicly traded market.

How should firms determine whether their historical grants are “in-the-money” (strike price > stock price), and how should they ensure that their future grants are not? The process for determine whether or not historical grants were issued “in-the-money” and for ensuring that the firms future grants are not issued “in-the-money” requires a firm valuation. According to the code any “reasonable” valuations must consider the following areas:

- The value of tangible and intangible assets of the company
- The present value of future cash flows
- The public trading price or private sale price of comparable companies
- Control premiums and illiquidity discount for lack of marketability
- Whether the method is used for other purposes
- Whether all available information is taken into account in determining value

Initially it was believed that all historical grants would have to comply with the requirement that options were issued “at-the-money” (strike price equal to stock price), meaning firms would need historical valuations to ensure that historical grants were compliant. The IRS recently addressed the treatment of option grants issued prior to Jan. 1, 2005 in “Notice 2006-4.” Unfortunately, the IRS was inconclusive and as a result it is difficult to determine whether or not the highest level of diligence will be required from firms – e.g. separate valuation for all historical grants.

The reason for this uncertainty is that the IRS stated that firms who historically made a “good-faith” effort to set the strike price of the options equal to the stock price could feel comfortable in their valuations, and subsequent liability. The question is though, “What constitutes a ‘good-faith’ effort in the eyes of the IRS?” If this implies that firms had to

follow all of the guidelines set forth under Section 409A then it is likely that most firms will need additional valuations. With this definition still unclear, it may be smart for firms to ensure that their last few years of grants meet the requirements of the new code.

The question of whether or not to conduct the valuations yourself or to outsource this work to a third party comes down to burden of proof and liability. If the firm does the valuation itself and the IRS deems it as “unreasonable” then the burden of proof will fall on the firm to show that the valuation and methodology was “reasonable.” In addition, the firm will find itself liable for the back-taxes owed by its employees. If, however, a qualified third party conducts the valuation, the burden of proof falls on the IRS and the tax liability is shifted from the firm to the third party conducting the valuation.

What should firms do if they find that their historical grants are “in-the-money”? At this point, firms should follow the only corrective action still available which is to raise the strike price of the option to the fair-market value, or stock price, on the day of grant.<sup>3</sup> Firms can then issue the optionee a cash or stock bonus (which will be taxable) to make up for their loss in option value. If the firm wants to make this amount subject to vesting, then it must comply with the previously mentioned requirements set forth in the code.

#### *Restricted stock units (RSUs)*

Restricted stock units generally do not fall under Section 409A as long as stock is not issued within 13 months of grant, they are issued at the time of vesting or within 2 ½ months of the taxable year end, and the recipient makes their deferral election within 30 days of the initial grant.

#### *Phantom stock plans*

These plans are similar to “cash settled” stock appreciation rights (SARs). Basically, these plans work just like traditional employee stock options, but at the time of exercise the difference between the strike price and the stock price is paid out in cash. The result is a unit that rewards gain in firm value but results in no issuance of equity or dilution of existing stock rights. Because of their similarity to ESOPs, phantom options require the same diligence in assuring that the strike price is equal to the stock price on the day of grant.

#### *Dividend Equivalent Units (DEUs)*

Section 409A has unique implications for dividend equivalent units or DEUs. Under these plans companies can choose between two alternatives: (1) They can distribute DEUs within 2 ½ months after the end of the calendar year in which the dividends are paid to shareholders of that class of stock, or up until the 15<sup>th</sup> day of the third month after the distribution (2) Companies may chose to retain DEUs in the plan and distribute them at the time of the underlying shares.

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<sup>3</sup> Firms should examine the ESOP contract to ensure that this is allowable under the conditions of the plan. In addition, employees may be required to approve any changes.

### *Concluding remarks*

This article has hopefully shed some light on the range and the level of impact that IRS Code 409A has upon non-qualified deferred compensation. There is still time to organize a plan for total compliance, but firms should be proactive in addressing the various issues raised by the code.

A few final points:

- The IRS will begin auditing in 2007<sup>4</sup>, so again there is time to address current and historical plan issues
- Any firm valuations that are conducted for the purpose of ensuring an “at-the-money” grant are good for 12-months from the date of the valuation.
- If you are unsure about any of the information provided in this document please contact a qualified party as soon as possible.

We hope that this article has proven itself informative, and we look forward to providing more information on compensation and firm valuation issues and concerns from the perspective of the privately held firm.

*If there are any question about this or any other compensation or valuation related issue please contact:*

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<sup>4</sup> Again, this date has been pushed to January 1, 2007.