Practical Considerations to Section 409A M&A Issues

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Section 409A of the Internal Revenue Code of 1986, as amended ("Section 409A"), sets forth certain requirements for nonqualified deferred compensation plans.[1] As M&A activity gains steam after the recent economic and market turmoil and downturn, the purpose of this article is to address certain Section 409A issues that may arise during a corporate transaction. The due diligence preparation and review process connected with a transaction will likely put renewed focus on Section 409A compliance and require companies to address their own Section 409A concerns and those of potential parties to the transaction.

The first part of this article provides an overview of Section 409A, particularly in the transaction context. While not intended to be an exhaustive layout of the law, it is meant to provide non-Section 409A practitioners a brief introduction to the principle Section 409A deal provisions. The second part of the article addresses certain Section 409A issues that may arise during a transaction and possible solutions to such issues.[2]

Brief Primer to Section 409A in the Transaction Context

Introduction

Section 409A, added to the Internal Revenue Code effective as of January 1, 2005, significantly altered the income tax rules for nonqualified deferred compensation plans. As supplemented by regulations and other guidance, Section 409A introduced an often complex and intricate series of rules for such plans that have potentially severe tax consequences to employees. Section 409A provides specific rules for the operation of such arrangements, including rules for payment form and timing. If a deferred compensation plan meets the Section 409A requirements, an employee is taxed on the plan distributions when made. If the arrangement fails to meet these requirements, an employee faces adverse tax consequences on the deferred compensation, including being taxed currently on vested deferred income (regardless if paid out at a later taxable year) and being subject to a 20% excise tax, in addition to regular income tax, as well as enhanced interest penalties on such amounts.

Section 409A applies to deferred compensation arrangements of all employees; it is not limited to only officers or executives.[3] Given the expansive application and broad definition of deferred compensation[4] under Section 409A, the universe of plans that may need to be reviewed in the deal context is extensive. The following, while not all inclusive, are arrangements that should be reviewed:

- Supplemental executive retirement plans;

- Supplemental deferral or "excess" plans;
- Equity plans and awards (including phantom stock and restricted stock units);
- Employment agreements;
- Severance/separation plans and agreements;
- Change in control agreements;
- Bonus and incentive compensation plans or programs; and
- Consulting and retention agreements.

The Section 409A transition relief period ended at the end of 2008, and companies are now required to have their Section 409A plans compliant in form and operation under the various regulations and guidelines. Moreover, while good-faith operational compliance was required prior to January 1, 2009, the IRS has recently begun auditing such plans for compliance issues.

Change in Control under Section 409A

Nothing in Section 409A, or its corresponding regulations, prevents employers from making distributions under a deferred compensation arrangement. The law only provides adverse tax consequences if such a distribution does not, so to speak, follow the rules. Under Section 409A, distributions may avoid the stiff tax penalties if they are made upon certain specified events. One such event is a change in control.[5] There are three types of occurrences that constitute changes in control under Section 409A:

- Change in the Ownership. A change in the ownership of a company occurs on the date that any person[6] obtains stock ownership that, together with previously held stock, constitutes more than 50 percent of the total fair market value or total voting power of the stock of the company. A change in control does not occur where such person already owns more than 50 percent of a company's stock at the time of acquisition. The percentage utilized may be higher (but not lower) than 50 percent.
- Change in the Effective Control. A change in the effective control of a company may occur in two separate and distinct ways. First, a change in effective control occurs on the date that any person acquires, or has acquired during the preceding year, ownership of 30 percent or more of the total voting power of the company. A change in effective control also occurs on the date that a majority of the company's directors is replaced during any 12-month period by new directors whose appointment is not endorsed by a majority of the board before appointment. Similar to the above, a plan may choose an amount higher than 30 percent. Additionally, where a person effectively controls a company, the acquisition of additional control does not cause a change in control.
- Change in the Ownership of Substantial Assets. This occurs on the date that any person acquires, or has acquired during the preceding year, assets from the company that amount to 40 percent or more of the total gross fair market value of all of the assets of the company immediately prior to the acquisition. Again, a plan may specify a higher amount. A change in control event does not occur when the transfer of assets is to an entity that is controlled by the shareholders of the transferring company immediately after the transfer or to an entity controlled by the company or its shareholders as described under Section 409A.

Section 409A provides a certain amount of deference for those who are responsible for designing a plan. A plan may allow deferred compensation to be paid out upon the happening of any or all of the three types of change in control events. A plan may also choose not to permit payout of deferred compensation when any change in control event occurs. Flexibility exists only in the initial planning stages, however. When a plan is implemented, it must provide clear and objective change in control descriptions. The plan must specify when and if a change in control will trigger distribution, and the determination as to whether a change in control event has occurred must not be subjective. Section 409A penalties may apply if the plan's change in control criteria are not followed or are not compliant with the parameters set out under Section 409A.

Separation from Service in Asset Purchase Transactions and Spinoffs

Under Section 409A, plan distributions are also permitted upon a separation from service. A separation from service occurs when an employee dies, retires, or otherwise terminates employment. Whether a termination of employment has occurred is based on a "facts and circumstances" test. If the facts and circumstances indicate that the employer and employee anticipated that no further services would be performed after a certain date, a termination has occurred. Section 409A provides a set of presumptions to assist in the separation from service determination, with the presumption keying off a comparison of the amount of work currently being performed versus the amount of work performed in the past.[7]

Special rules apply in determining whether a separation from service has occurred in an asset purchase transaction. In a sale of assets, the buyer and seller may choose whether an employee of the seller will experience a separation from service when the employee is providing services to the seller immediately before the asset sale and is providing services to the buyer after, and in connection with, the sale. This rule, known in other contexts as the "same desk" rule, gives discretion to the seller and buyer to determine whether a separation occurs. It is only applicable when the asset sale is the result of a bona fide, arm's length negotiation. All employees providing services to the seller immediately prior to the asset sale must be treated consistently.

Where a plan defines separation from service to include any action that results in an employee no longer being employed at the company, a spinoff of a subsidiary seems problematic. However, it is possible to avoid a separation in this circumstance. Section 409A provides that, in a spinoff transaction, the employee would not be terminated as an employee of the subsidiary and no separation from service would occur. Essentially, the employee is treated as continuing service with the same employer before and after the spinoff.

Plan Terminations

Deferred compensation plans that are subject to Section 409A generally may not accelerate the time, schedule, or amount that is scheduled to be paid under the terms of the plan. In the event that a plan is simply terminated and paid out, it would be treated as an impermissible acceleration of payments. However, limited circumstances may exist to allow a plan to be terminated, and payments to be made, without recourse.

A company may terminate and liquidate a plan, and thereby accelerate any payments, when the termination occurs within the 30 days prior to, or the 12 months following, a change in control event. Such termination does not violate the anti-acceleration rule, so long as all similar arrangements are also terminated.

Outside of the change in control context, a company may also terminate or liquidate a plan if the following requirements are met:

a. the termination and liquidation do not occur proximate to a downturn in the company's financial health;

b. each similar plan that is subject to aggregation is terminated and liquidated;
c. no liquidation payments are made within 12 months of the date the employer takes the actions necessary to irrevocably terminate and liquidate the plan;
d. all payments are made within 24 months of the date the employer takes all necessary actions to irrevocably terminate and liquidate the plan; and
e. the employer does not adopt a new plan within three years of the date the employer takes all necessary actions to irrevocably terminate and liquidate the plan.

Possible Section 409A Issues and Solutions in the Transaction Context

Keeping a Key Employee Who Has a "Walk Away" Right after the Transaction

Example of Issue: Seller has an agreement with a key employee that provides a severance payment if the employee voluntarily terminates within a set time period after a qualified change in control transaction. In this example, the employee's severance payment only vests upon the change in control transaction (i.e., the payment ceases to be subject to a substantial risk of forfeiture at such time). Buyer would like the key employee to stay with the new company after the transaction beyond the "walk away" period set in the agreement. For example, the employee may be working on a key project that will continue after the walk away period, and Buyer wants to ensure that the employee stays on the project.

Possible Solution: Section 409A provides a limited "skipping" right for nonvested compensation that vests as a result of certain change in control events.[8] In such a circumstance, the transaction and accompanying walk away right could be ignored in determining the severance payment. Of course, the key employee would likely need incentive to agree to the "skipping" treatment. One form of incentive would be to transform the severance amount into a retention bonus by making such amount payable upon (i) the employee being employed at the end of a set duration after the transaction (e.g., the time period that the employee's service on a key project is expected to end), and (ii) the employee being terminated without cause prior to that time.

It is important to note the following with respect to the Section 409A "skipping" provision:

- It must be done prior to the transaction.
- The provision does not apply to change in control events arising due to a "change in effective control."
- The provision only applies to nonvested compensation (i.e., compensation still subject to a substantial risk of forfeiture) – whether compensation is vested under Section 409A can sometimes be an intricate analysis.
- The substantial risk of forfeiture that exists after the transaction must still meet the applicable standards under Section 409A.
- This typically cannot be done unilaterally and requires the employee to buy-in.

Impermissible Change in Control Payment Trigger

Example of Issue: Seller has a plan subject to Section 409A that has multiple payment events, including a change in control that, unfortunately, does not meet the requirements of Section 409A. For example, the plan definition uses a threshold percentage for change in ownership that does not meet the minimum prescribed by Section 409A. Seller and/or Buyer want to fix the issue.

Possible Solution #1: In Notice 2010-6, the IRS provided some ability to correct certain Section 409A document failures, including impermissible change in control definitions.[9] The plan may be corrected before the date the impermissible transaction event occurs. The correction occurs by amending the plan to provide for a change in control event that satisfies the requirements of Section 409A, provided that the amendment may not cause an event that was not a payment event under the original terms of the plan to become a payment event under the new terms of the plan. For example, one cannot fix a bad change in ownership definition by replacing it with a change in substantial asset event. The amendment must take effect immediately.

If, within one year following the date of correction, a transaction occurs that is not a change in control event under Section 409A and results in the corrected plan provision being applied to avoid a payment that would have been due under the pre-correction plan provisions, 25 percent of the amount deferred under the plan to which the prior plan provision applies must be included in income under Section 409A (and subject to the Section 409A penalties) by the affected plan participants.[10]

In order to take advantage of the preceding correction procedures, the company and plan participants are subject to certain information reporting requirements with respect to their respective tax filings for such year.

Possible Solution #2: If the deferred compensation under the plan is nonvested, there may be an opportunity under the proposed Section 409A income inclusion rules to fix the impermissible change in control definition.[11] These rules provide that nonvested deferred amounts generally would not be includible in income under Section 409A in the year of the impermissible change in time and form of payment (e.g., the year the noncompliant plan provision was implemented). In the subsequent taxable year in which the plan participant becomes vested in the deferred amount, the plan might comply with Section 409A in form and operation, so that no income inclusion would be required and no additional taxes would be due for that year as a result of the previous noncompliance. Thus, there is an opportunity to make plans compliant with Section 409A for nonvested amounts.[12]

A few things to consider with respect to taking advantage of the proposed Section 409A income inclusion rules:

- This correction opportunity is provided under proposed regulations in a brief manner and is subject to change in the future. Additionally, before the date of the final regulations, companies may rely on the proposed regulations only to the extent provided in further guidance. Thus, there is some risk that reliance on this correction mechanic may be undermined in future guidance. However, one would hope that the Internal Revenue Service would ultimately provide some sort of good faith reliance standard or transition assistance.
- As indicated earlier, the correction opportunity only applies to nonvested compensation, and determining whether compensation is vested under Section 409A can sometimes be an intricate analysis.
- It is currently unclear whether the ability to make the correction could occur in the year in which vesting would otherwise occur or whether it must occur in a prior year.
- There is no reporting requirement on the company or plan participants under this correction opportunity.

Non-Matching Transaction Payment Provisions between Plan Participants and Shareholders

Example of Issue: Seller has a restricted stock unit plan subject to Section 409A that provides for immediate payment upon a permissible change in control event. However, the transaction contemplates that Seller's shareholders will be paid in installments over a period of time for the acquired stock. Seller and/or Buyer want to address the disconnect between the payment timing for Seller's shareholders and the restricted stock unit plan participants.

Possible Solution: Section 409A provides the ability for certain transaction compensation, payable as a result of certain change in control events, to be paid at the same schedule as other shareholders. Payment of compensation that is calculated by reference to the value of the company's stock may be treated as paid at a designated date or pursuant to a payment schedule that complies with the requirements of Section 409A if it is paid on the same schedule and under the same terms and conditions as those that apply to the shareholder's payments. However, payments must be made no later than five years after the change in control event. Such payment of compensation will not violate the initial or subsequent deferral election rules set out under Section 409A.

It is important to note the following with respect to this Section 409A provision:

- The provision does not apply to change in control events arising under a "change in effective control."
- The provision applies regardless of whether the deferred compensation is vested or nonvested.
- Whether this provision can be implemented unilaterally or with the consent of the plan participants will likely depend on the particular provision of the plan. To the extent that plan participant cooperation can be obtained (e.g., the transaction and value will not occur without cooperation), getting plan participant sign-off on the change makes sense.

Conclusion

As M&A transactions again begin to rise, companies should be mindful of Section 409A's extensive requirements in the planning stages and throughout the length of a deal. It is expected that the regulations will be more strictly enforced in the near future, and the necessity for compliance is high. Penalties for violating Section 409A are strict and, if imposed, could have serious repercussions for employees. While Section 409A and its regulations and corresponding guidance are complicated and lengthy, it is not impossible to comply. Careful planning and supervision should ensure that M&A transactions proceed smoothly in the Section 409A arena.

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[1] Generally referred to as "plan" or "arrangement" in this article.

[2] This article does not address issues that may arise due to other tax doctrines such as constructive receipt or the economic benefit doctrine, or due to the requirements of Section 457 of the Internal Revenue Code for deferred compensation plans of tax exempt organizations (and state and local governments), and

assumes that these are not issues for purposes of the article's analysis.

[3] Other service providers such as independent contractors and directors are also covered by Section 409A. This article generally references employees, but the analysis may pertain to other service providers as well.

[4] A plan provides for the deferral of compensation if, under its terms and the relevant facts, an employee has a legally binding right during a taxable year to compensation that is or may be payable to the employee in a later year.

[5] Other permissible distribution events include an employee's separation from service, death, disability, unforeseeable emergency, or at a fixed time or schedule specified under the arrangement.

[6] For purposes of a change in control under Section 409A, person generally also refers to a group of persons. Note that persons will not be considered to be acting as a group simply because they purchase or own stock at the same time. However, persons acting together will be considered a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation.

[7] An employee is presumed to have separated from service in the instance where the employee is providing services at a level that is 20 percent or less of the average services provided in the three preceding years. On the other hand, an employee is presumed to not be separated where the employee is providing services at a level that is 50 percent or more of the average services provided in the three preceding years. To provide flexibility, a plan may choose to specify a service requirement threshold higher than 20 percent and less than 50 percent.

[8] Generally, Section 409A does not permit the extension or modification of the original conditions on payments that constitute a substantial risk of forfeiture. However, a condition that is a substantial risk of forfeiture that otherwise would lapse as a result of a "change in the ownership" or "change in the ownership of substantial assets" event may be extended or modified before, and in connection with, such event to provide that the substantial risk of forfeiture will not lapse as a result of such change in control event. Such extended or modified condition will be treated as continuing to subject the amount to a substantial risk of forfeiture, provided that the transaction constituting the change in control event is a bona fide arm's length transaction between the company or its shareholders and one or more unrelated parties, and the modified or extended condition to which the payment is subject would otherwise be treated as a substantial risk of forfeiture. In such a case, the continued application of a fixed schedule of payments based upon the lapse of the substantial risk of forfeiture, so that payments commence upon the lapse of the modified or extended condition on payment, will not be treated as an impermissible change in the fixed schedule of payments.

[9] In general, companies are eligible to take advantage of the Notice 2010-6 correction procedures so long as the company is not under examination with respect to nonqualified deferred compensation for any taxable year in which the document failure existed.

[10] According to Notice 2010-6, if the correction was implemented in 2010, the 25% income inclusion requirement may not apply.

[11] Depending on the operations and provisions of the plan in question, payment upon the impermissible change in control definition may be acceptable if the plan and payment satisfy the short term deferral exception under Section 409A.

[12] Note that this is subject to an abuse standard such that if the facts and circumstances indicate a pattern or practice in this regard, the correction opportunity will not be available.