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**Comp Talks
Section 409A
Tips and Traps**

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What's our Agenda?



- Section 409A overview and background
- Equity awards
- Non-employee director arrangements
- Employment and severance arrangements
- Top-hat plans
- Mergers and acquisitions
- Correction of errors

- We will not discuss additional considerations applicable to private entities (unless we are buying them)



Remind me, what exactly is Section 409A?

- Part of the Internal Revenue Code
- Complex and sometimes counterintuitive set of rules with a very broad scope applicable to many compensation arrangements not generally viewed as “deferred compensation”
- Unless an exception is available, Section 409A applies to all arrangements under which a service provider has a legally binding right (i.e., contractual promise) to compensation payable by a service recipient that may be paid in later taxable years

Why Does Section 409A Matter?



It's all about the Benjamins

- Adverse tax consequences to the service provider for non-compliance:
 - Immediate income recognition (even if value has not yet been and may never be paid due to unsatisfied contingencies)
 - Additional 20% federal tax
 - Additional corresponding 5% tax for California taxpayers
 - Premium interest penalties
- Strict liability compliance standard (intent is irrelevant)

Equity Awards

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Stock Options

- Exempt if either “incentive stock options” or exercise price otherwise not discounted on grant date
- Traps:
 - Modification after the grant date that directly or indirectly reduces the exercise price
 - Disguised discount exercise price (e.g., bonus payable if option is exercised)
 - Extension of maximum term of in-the-money options
- Always first check with benefits counsel regarding tax impact of any proposed option modification



Restricted Stock Units

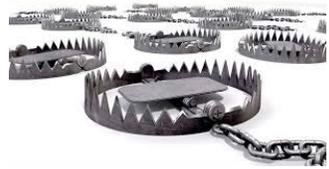
- Generally exempt if shares are issued on the date of vesting

- Traps:

- Deferring issuance until an open trading window to allow sell to cover
- Vesting may accelerate per terms of severance or change of control arrangement that is not Section 409A exempt

- Tips:

- In all cases require shares to be issued no later than March 15th of the year following the vesting year
- Coordinate review of equity vesting acceleration provisions with counsel



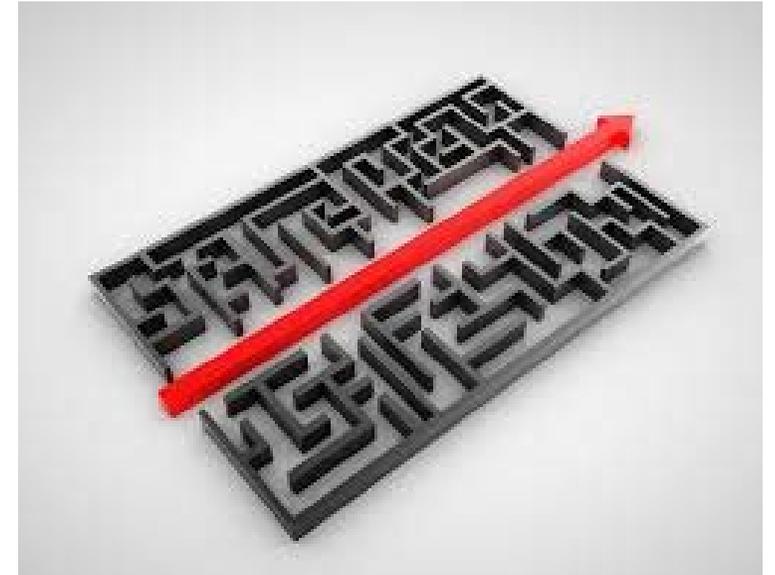
Performance-Based Awards

- Increasingly seeing the use of performance-based RSUs with longer performance periods (e.g., 3 years)
 - Traps: Interaction of provisions for acceleration of payment and/or waiver of service condition requirements due to intervening events (e.g., change in control, retirement, death, disability, termination without cause, good reason resignation) prior to expiration of performance period
 - Tip: Keep payout design simple



Deferred RSUs—Participant Deferral Election Rules

- If RSU grantee is given opportunity to make deferral election, special timing rules apply to the election
 - Must be made no later than December 31st of year preceding RSU grant
 - Must be made no later than 30 days following grant, and RSU cannot potentially vest any earlier than 12 months following latest permitted date for making the election (i.e., the “13 month vesting” rule)
 - Special election timing rules for “performance based compensation”



Deferred RSUs—Design



- Defer delivery of shares—and therefore ordinary income tax—on vested RSUs until one of Section 409A permitted payment events:
 - Section 409A “separation from service” (6 month delay for specific employees)
 - Fixed date(s) or calendar year (e.g., February 15, 2018, or calendar year 2018)
 - Section 409A “change in control”
 - Section 409A “disability”
 - Death (see IRS Notice 2007-90)
 - The “undead regulations”





Deferred RSUs—Design Traps



- Problems with deferral election timing or payment (issuance) events
- Deferral was permitted under “30 day” rule, but vesting may accelerate within one year of the deferral election (e.g., as part of severance benefits)
- Upon an acquisition of the entity the board has the discretion to accelerate the issuance of all equity plan award shares at or before closing
 - Special exception may be available on CIC if all “aggregated” deferred comp plans terminate and payout at issuer’s discretion (not available if need service provider consent)

Deferred RSUs—Compliance Tips

- Get benefits counsel involved early with performance-based RSU design (before board approval of terms)
- Include Section 409A “savings clauses” into the form of RSU agreement
 - Automatic six month delay provision for any deferred RSUs that payout on separation of service to specified employee
 - Override any impermissible acceleration provisions in equity plan
- Check with benefits counsel before making any changes to vesting terms of RSUs (including as part of severance benefits)



Non-Employee Director Arrangements

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Non-Employee Director Deferrals—Alternatives



- Directors are often given the opportunity to elect to receive compensation in cash or equity, and/or to defer receipt of issuance of shares under RSUs
- Generally, any elective deferral must be made prior to the beginning of the calendar year for which the compensation is earned
- Director fees are often earned/awarded on an annual basis in connection with the annual meeting

General Tips and Traps

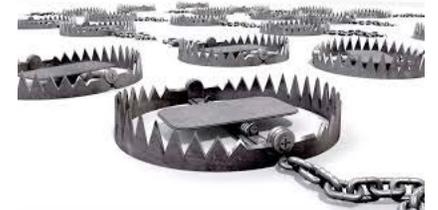


- Trap: Additional Section 409A compliance issues may arise because directors are effectively approving their own compensation
- Tip: Recommend being conservative and treating any compensation with a built in deferral feature (non-elective) as elected by the director, and administer in accordance with election timing rules



Initial Year of Eligibility Rule

- Special “initial year of eligibility” rule permits deferral election within first 30 days of becoming eligible to participate in a plan for amounts not yet earned
- Trap: Director fees are often payable or awarded or vest on an annual basis, and so partially “earned” on day one
- Tip: If thinking about adopting a new deferred comp plan for directors, get benefits counsel involved as early as possible
- Tip: May need to provide initial deferral election forms and require return prior to commencement of board service for newly appointed directors



More Tips and Traps

- Trap: Director may elect form of equity award to be granted next year, including whether to receive a vested option or RSU with a deferral election permitted or delayed issuance built into the terms
- Permitting election between receiving deferred compensation (RSUs) and option will mean that the option is non-exempt and non-compliant if selected
- Tip: Get benefits counsel involved with any equity award elections



Employment and Severance Arrangements

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Bonuses



- Exempt if services required through payment date
 - Trap: Any possibility of bonus payment on date not still employed?
 - Tips:
 - Require service through bonus payment date (exempt)
 - Specify payable no later than March 15th of year immediately following year for which bonus was earned (exempt)
 - Specify calendar year of payment (calendar year immediately following bonus year) (compliant)



Taxable Moving Expense Reimbursements

- Trap: Imposing a limit on maximum amount of expenses reimbursable where move may potentially occur and reimbursements be paid in more than one taxable year
- Tip: If not practicable to specify one calendar year for the move and reimbursements to occur, provide that regardless of when the expenses are incurred, the reimbursement payments will be made in a single (later) calendar year



Other Taxable Reimbursements

- For example, automobile lease, corporate apartment, other taxable fringe
 - Tip: Include reasonable deadlines for submission of documentation and reimbursement so all amounts will be paid no later than 12/31 of year following year in which expense is incurred
 - Tip: If caps/maximums are applicable, they should be monthly, quarterly or annual (i.e., no caps spanning multiple calendar years)

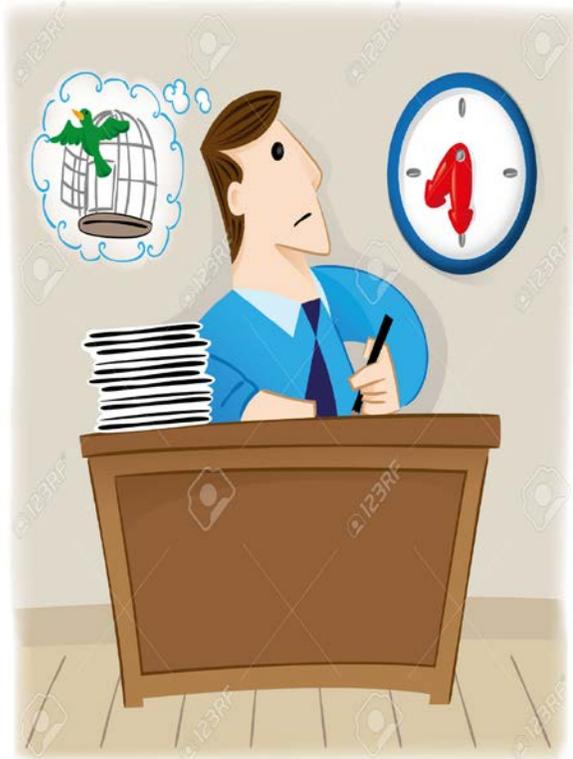


Severance Benefits—Design Considerations

- Should the benefits be compliant or exempt?
 - 6 month delay required for non-exempt benefits payable to “specified employees”
 - Limited ability to change timing of non-exempt severance payments
 - Limited payout triggers are permitted for exemption to be available



Potentially Non-Exempt Severance Benefits



- Severance benefits payable under circumstances other than “involuntary termination” where employee was otherwise able to continue providing services are potentially non-exempt
 - Good reason “constructive termination” resignation rights
 - Death
 - Disability
 - Walk rights (e.g., upon a change in control)

Severance Benefits—Safe Harbor

- “Safe harbor” resignation triggers under Section 409A
 - Material diminution in annual base compensation, authority, duties or responsibilities, or budgetary authority
 - Notably absent: Change in title, reduction of benefits
 - Material diminution in the authority, duties or responsibilities of the supervisor to whom employee is required to report
 - Material change in geographic work location
 - Material breach by the employer of the services agreement
 - Employee must provide written notice no later than 90 days after event, must allow at least 30 days to cure, resignation must occur no later than 2 years after.



Safe Harbor Exemption Tips

- Don't forget the materiality qualifiers in the good reason definition!
 - “Any” reduction in base salary won't qualify as exempt (per informal IRS guidance)
- Generally best to follow the safe harbor exemption language exactly, but instead phrase change in geographic location as increase in one-way commute that exceeds a specified distance



Severance Benefits Trap

- Trap: Continuing to provide services under a consulting arrangement after employment termination
 - If providing 20% or more of the prior level of services, then the default is that there is no “separation of service” and severance payments cannot commence



Top-Hat Plans

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Background

- Strict rules apply for timing of deferral elections and permitted payouts
 - Same payout events permitted as for deferred RSUs
 - Generally must irrevocably elect to defer compensation no later than 12/31 of the year before the year in which the compensation is earned
 - Once made, the deferral election cannot generally be changed
- Special mid-year election permitted for first year plan is adopted
 - Trap: Exemption is not available if RSU deferrals have previously been elected



Traps and Tips

- Trap: Ambiguity in plan documents regarding timing of payment when multiple payment events occur prior to full payment of plan accounts
- Design tip: Keep payout triggers simple
 - Full lump sum payout of all remaining accounts on any change in control
 - Be clear what happens if a separation from service occurs after specified date payments have already commenced



More Traps and Tips



- Tip: Keep administration simple by providing in the plan that all distributions triggered by a separation from service will be delayed six months
- This avoids the need for any determination of which participants are specified employees subject to a six month delay

Even More Traps and Tips

- Trap: If an “operational error” occurs with respect to any participant’s deferral election or payout, regardless of the amount, that participant’s entire account balance is “tainted” by that error and subject to Section 409A taxes if a timely correction is not made
- Tip: Conduct an annual audit of all top hat plan operations each year to verify all deferrals and payments have been administered correctly (even if there is an outside administrator)
- Tip: Closely review and negotiate any plan administrator agreements for limits of liability and indemnification terms



Mergers & Acquisitions

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Target Diligence

- Did private target have a valid Section 409A valuation of its stock for each of its option grants?
- All severance arrangements, carve out bonus plans, and deferred comp plans Section 409A exempt or compliant?
- Any executive election to forgo salary or other payments until next acquisition or financing?
- Any Section 409A corrective amendments necessary?
- Need to quantify any risk of non-compliance



Target Diligence



- Do target's deferred compensation arrangements permit elective acceleration of payments/benefits upon change in control?
 - Permitted under Section 409A if election is made solely at employer's discretion and all "aggregated" arrangements of the same type terminate and payout
- Trap: If plan terms do not give the entity the unilateral right to accelerate payout without getting consent of participants, it is not a permitted exception

Treatment of Target Equity

- Cancel and cash out for merger consideration
- General Section 409A prohibition against cancelling options in exchange for cash payment in a later taxable year
 - Contingent milestone/escrow payments
 - 5 year “transaction based compensation rule”
 - Substantial risk of forfeiture?
 - OK to cash out on option vesting schedule?



Assumption or Conversation of Target Options



- To comply with Section 409A:
 - the aggregate option spread after conversion must be less than or equal to aggregate option spread before conversion, and
 - the ratio of per share exercise price to per share FMV after conversion must be "not greater than" such ratio before conversion
- Translation: as long as the aggregate "spread" value is not exceeded, each option after the conversion may be more "in the money" than before the conversion
- Trap: How do you convert in compliance with Section 409A based on current FMV determination of acquired entity's stock when a portion of the merger consideration is contingent?

Assumption or Substitution of Target Options— Possible Conversion Approaches



- Obtain a 3rd party valuation to account for escrow in setting the option exchange ratio
- Convert portion of options as though escrow will be paid in full and subject a portion of options to cash out treatment and escrow forfeiture restrictions on basis of spread value necessary to avoid Section 409A conversion violation (a percentage of options will need to be cashed out and subjected to forfeiture contingent on escrow payout greater than the escrow percentage of deal price to get the option conversion ratios to work)
- Convert all options as though no escrow is ever paid to shareholders (i.e., at 90% of deal price)
- Tip: Get benefits counsel involved early whenever assumption of options is being considered as part of deal terms (ideally prior to or during negotiations) to verify that desired treatment is workable under tax rules

Final Thoughts (on Mergers & Acquisitions)



- If there are plans to potentially sell in the foreseeable future, consider a pro-active Section 409A documentary compliance audit and implementing any necessary corrections/clarifications before disclosing any diligence materials to a potential buyer

Correction of Errors

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Compliance Errors

- Formal correction programs are available for both plan document and operational errors
- Other correction methods may be available outside the formal correction program
- Tip: Timing is everything! The earlier the compliance error is identified and addressed, generally the less expensive the correction will be



Document Error Correction—IRS Notice 2010-6

- Each specified error that is eligible for correction has its own particular correction methodology
- Neither the service provider nor the service recipient may be under examination
- Must also correct any other “similar” plan document errors
- Generally must file notices of correction to the IRS with both the individual and the corporate tax return for year in which correction is completed
- Payment of a portion of the Section 409A tax penalty may be required as part of the correction



Operational Errors—IRS Notice 2008-113

- Available for correction of unintentional operational failures:
 - Premature payments of amounts that otherwise should have been deferred
 - Failures to delay payments upon separation of service to specified employees for six months
 - Deferrals of amounts that should not have been deferred
 - Discounted options
- Different correction rules/procedures apply to Section 16 insiders (not as beneficial)



Consequences of Uncorrected Errors



- The good news:
 - Plan document errors affect only those service providers and amounts that are covered by the non-compliant plan provisions



- The bad news:
 - Operational errors affect all amounts deferred by the same service provider under any plan of the same type that would be aggregated with the plan under which the error occurred
 - Amounts are recognized in income and income tax withholding applies at the time of vesting, not time of payment
 - If not timely corrected, service recipient must report amounts subject to error as immediately recognized in income by the participant and subject to additional Section 409A taxes on Form W-2 and 1099-MISC

Tips for Correcting and Avoiding Errors

- Conduct periodic Section 409A operational compliance audits, ideally on an annual basis during October/November so that any errors can be found and corrected prior to year end
- If any error is found, do not take any action (e.g., payout of erroneous deferral, amending agreement) before consulting with counsel familiar with Section 409A issues
- If changes have been made to forms of agreements over time without outside legal review, have them periodically scrubbed to verify Section 409A and other legal compliance



Questions????

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