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Los Angeles | Daily Journal
TUESDAY, MARCH 5, 2013

What every lawyer should know about Section 409A

By Robert W. Wood

This is a tough subject. Lawyers as a rule don't like tax law. They know they must pay tax, and they know tax rules are complex. But surely that is what accountants and tax lawyers are for, right? One answer to this common viewpoint is that it is quite true that tax specialists can be brought in.

However, lawyers must know enough about tax law to recognize when they need to obtain that tax advice. That triage function can be vexing. One of the toughest issues to identify relates to Section 409A of the tax code. Many lawyers have probably encountered it without knowing it, and that in itself is frightening, as you'll see.

Section 409A is about when money is currently taxable even though you can't get it. Much of tax planning involves pushing payment and taxes into the future. Most lawyers know that tax rules hinge partly on receipt and partly on "constructive receipt" — where you are taxed because money was available to you even though you chose not to take it.

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In 2004, Congress sought to stop executives (and others that Congress seemed to label as "fat cats") from pushing income into the future and deferring it. One can often delay payment by contract and do so in a way that does not run afoul of the tax concept of constructive receipt. Within limits, you can contract to receive income and be taxed later.

But in 2004, new Section 409A of the tax code changed the rules dramatically. (The tax code is such a behemoth that we must now resort to letters as well as numbers.) At its root, Section 409A provides that some compensation you defer under regular tax rules must nevertheless be currently taxed.

Specifically, any amount deferred under a nonqualified deferred compensation plan is currently taxed if it is not subject to a "substantial risk of forfeiture." A substantial risk of forfeiture has a defined meaning and refers to events that could prevent you from getting it. But without conditions, if a plan says you will get the money in three years, Section 409A says it is taxed now, even if you can't get any of the money to pay your tax!

Fortunately, there are exceptions that allow you to fall outside this harsh rule and back into traditional deferred compensation rules. First, you don't have to worry about "qualified" plans like pension plans or your 401k. However, a "nonqualified deferred compensation plan" includes virtually any agreement, method, program or other arrangement that provides for deferral of compensation, where the compensation is not paid until a later tax year.

What constitutes a "plan"? Any employment contract, bonus or compensation agreement where money is paid later; supplemental executive retirement plans (sometimes called SERPs) and other nonqualified retirement arrangements; restricted stock, phantom stock and performance share plans; stock appreciation rights; and long-term or multi-year bonus or commission programs.

In fact, you should assume that virtually any kind of deferred compensation arrangement under which money is paid later is covered by Section 409A. Change in control agreements, severance agreements, employment agreements, agreements covering the delayed payout of option proceeds are all fair game.

Lawyers drafting employment and consulting agreements should pay attention and involve a tax adviser whenever payments are not immediate. So should lawyers involved in business sales. Different considerations apply to public and private companies, for Section 409A has even longer teeth when it comes to publicly held entities.

As one example, there is a six-month delay in the case of distributions to key employees from publicly held corporations. Buyers and their counsel should be sure to review all of the target company's nonqualified deferred compensation plans and agreements.

Stock options

Stock options are generally treated as nonqualified deferred compensation under Section 409A if the stock options have an exercise price that is less than the fair market value of the underlying stock on the date of the grant. A shorthand way of referring to them is options that are "in the money" when they are granted. You can avoid this rule by pricing options at fair market value when the options are issued.

If you or your client is buying an existing business, the purchase may involve the acceleration or cashing out of options. Carefully review the target's option practices, including resolutions and option grants to verify pricing. Also consider whether there has been a "material modification" of the options. Some modifications are treated as new options so the "in the money" option problem can arise where you don't expect it.

Apart from stock options, other types of equity interests should also be reviewed. One key issue is the extent to which options or equity are granted based on an exercise price that is equal to or greater than fair market value. Another is payments that are delayed but seem certain to occur.

Severance and employment agreements

Severance agreements, employment agreements and consulting agreements are prime places to encounter Section 409A. Often, such agreements offer replacement consideration for deferred compensation benefits that will not be available.

This is important, since payment of benefits that act as a substitute for deferred compensation can also be subject to Section 409A. The right to the new payment or agreement can be considered an impermissible acceleration of the forfeited deferred compensation.

This abbreviated discussion only scratches the surface of the potential impact of Section 409A. It can crop up wherever payments are delayed or contingent. For lawyers and taxpayers, a major goal is to have taxes due only when money is actually paid, not before. On top of the usual constructive receipt tax rules, one must also be able to recognize when Section 409A may apply. Good luck!

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