Concord Specialty Risk®

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ADDRESSING DEFERRED COMPENSATION TAX RISKS

This outline presents an overview of the due diligence that should be undertaken to determine if a company's deferred compensation plans have a significant exposure to taxes. Because the final regulations governing this topic are over 390 pages in length, this outline is, by necessity, an overview and not intended to address all nuances of the governing or applicable law. The purpose of this outline is to guide the reader in discovering common instances in which a significant tax risk is presented by a deferred compensation plan issued by a company involved in a merger, acquisition or other relevant transaction.[1] Where the tax exposure is significant but uncertain, the risk may be transferred via tax insurance.

I. <u>Potential Loss</u>

A. Any "deferred compensation" that fails to satisfy Section 409A of the Internal Revenue Code of 1986, as amended, exposes the

- Deferred compensation recipient (i.e., the service provider/officer, employee or contractor) to the following types of loss:
  (1) Potential acceleration of income, resulting in tax on money not received;
  (2) Additional "excise" tax equal to 20% of the compensation required to be included in gross income;
  (3) Enhanced interest rate applied to taxes that should have been paid; and
  (4) Potential penalties (e.g., negligence and failure to pay).

- Deferred compensation payor (i.e., the service recipient/employer) to the following types of loss:
  (1) Potential indemnity obligations owed to recipient;
  (2) Failure to withhold penalties; and
  (3) Challenge to the deduction for compensation (unreasonable since it violates Section 409A).

B. In addition, some states, most notably California, follow the federal 409A regime, so the additional excise tax, for example in California, would be a combined 40% of the (potentially accelerated) compensation above combined income tax rate (which may be

[1] *This article is intended only as a general discussion of these issues. It is not to be construed as or intended to replace legal advice. Pursuant to U.S. Treasury Department Circular 230, unless we expressly state otherwise, any tax advice contained in this communication was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties or (ii) promoting, marketing or recommending to another party any matter(s) addressed therein. No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.*

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another 40% - hence, 80% of the actual or accelerated compensation would be paid to tax authorities)!

II. Spotting Potential Risks of Loss in Due Diligence

A. "Deferred Compensation"

(1) Identify plans or arrangements that are subject to Section 409A

(2) Generally, all non-qualified arrangements are subject to Section 409A, such as:

- Non-qualified stock option plans
- Severance agreements
- Bonus plans
- Change-of-control payments
- Supplemental executive retirement plans
- Equity plans and awards including phantom stock and restricted stock units
- Consulting agreements which defer compensation

(3) Common theme is that there is an arrangement by which compensation is deferred (i.e., there is a legally binding right to receive a future payment for services rendered) via something other than a qualified plan, such as a retirement plans or 401(k) plans.

B. To satisfy Section 409A, a deferred compensation plan must either:

(1) Comply with Section 409A as of December 31, 2008;

(2) Be exempt from Section 409A; or

(3) Be excluded from Section 409A.

C. To comply with Section 409A, the plan must satisfy the following four requirements:

(1) **Timely Election**

- Service provider made the initial election to defer compensation either (i) before the year in which services are provided or (ii) within the first 30 days of participation and before deferred compensation was earned.

(2) **Deferred compensation is set (by amount or formula) and is only and always payable upon a set date, fixed schedule or occurrence of "particular events"**

- This is the most frequent stumbling block.
- Particular events, which must be specified in the plan to comply with Section 409A, are: (i) separation from service; (ii) death; (iii) disability; (iv) change in ownership or control of the company; and (v) unforeseen emergency.

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- Detailed rules restrict the meaning of certain of these events but essentially seek an "objectively determinable date of payment" completely outside the control of the recipient of the deferred compensation.

(3) **No Acceleration or Substitution.**

- Apart from a few exceptions, such as compliance with a domestic relations order (e.g., equitable distribution as part of a divorce decree) or plan termination (in which case there are a few narrow exceptions), the deferred compensation cannot be directly or indirectly paid ahead of schedule.

(4) **Later Deferral Elections Satisfy Rules**.

- Additional rules must be satisfied if deferred compensation may be subject to additional deferral via form of payment or timing of payment by the election of the service provider.

D. The following are the key exemptions and exclusions from Section 409A.

1. **The short-term deferral rule**.

Payments made within two and a half months after the end of the taxable year (of either the service provider or the service recipient) where the right to such payments was no longer subject to a "substantial risk of forfeiture" are exempt from Section 409A.

This is a key exemption; however, it is subject to a "facts and circumstances" scrutiny and is therefore inherently uncertain, especially where the officer/employee may have influence over corporate decisions.

(A) "Substantial risk of forfeiture" is defined for Section 409A purposes with slight modification to the definition of the term as used in Section 83 of the Code. An elective deferral, for example, where the employee has the choice to receive compensation currently or in the future, will not qualify for purposes of Section 409A.

(B) If a payment is conditioned upon the occurrence of an event (such as separation from service or change in control) that may occur at the end of the two and a half month period, it is "deferred compensation" that may or may not be subject to a "substantial risk of forfeiture" depending upon whether the condition is within the control of the employee (e.g., voluntary termination or company president negotiating for sale of the company).

(C) If plan permits deferral beyond the 2 and ½ month period, the exemption is not applicable.

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2. **Other exemptions and exclusions specific to**:

   (A) Stock options: if exercise price at time of grant can be established as not below fair market value and other rules satisfied (if privately held company, generally need an appraisal and there is uncertainty);

   (B) Promises to grant restricted property: e.g, deferred compensation payable in restricted stock that, when issued, is not transferrable and subject to a "substantial risk of forfeiture";

   (C) Severance payments: when provided by a collective bargaining agreement, or in the case of certain foreign plans, or when the amount of severance does do not exceed the limit of Section 402(g) of the Code – generally two times the lower of annual compensation or statutory ceiling, as adjusted each year – $255K in 2013, etc.

   (D) Plan termination based upon "change in control": When the deferred compensation plan does not provide for a "change in control" but is terminated as a result of a "change in control" to an unrelated party, an exclusion may be applicable.

III. Examples of Non-Compliant Plans With Tax Uncertainty

A. **Non-qualified stock option plan** granting set amount of options at stated exercise prices depending upon when exercised over next five years. Options fully vest when granted, except if employment terminated with cause or for voluntarily terminated by employee, then rights forfeited. Upon sale of the company, options may be canceled to extent not exercised in exchange for payment determined by the board.

Analysis: Because the employee can determine amount paid at any time, the plan is not compliant. Also, the forfeiture options, other than possible sale of company, are not a "substantial risk of forfeiture." However, exemption or exclusion may apply; particularly, if underlying stock subject to restrictions.

B. **Separation from service payments made in connection with asset sale of company**. In connection with an asset sale, the purchaser of the assets will hire the majority of the company's employees. Some, but not all, of those employees will be allowed severance payments from the selling company.

Analysis: The so-called "same desk" rule gives discretion as to whether the seller and buyer determine that a separation from service occurs in connection with bona fide, arm's length sale. However, all employees must be treated consistently.

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C. **Bonus plan termination as part of a consolidation**. Two accounting firms create a new firm based upon a "merger of equals." The bonus plan will be paid out at closing, but the plan itself does not provide for a "sale of business" payment and includes "deferred compensation" because payments relate, at least in part, to services provided in prior tax year.

Analysis: If the two firms will be 50/50 owners of the new consolidated firm, the new entity is deemed a related party to each member firm and the exception for "change in control" is not applicable.

IV. Resolving the Risk Via Tax Insurance

A. **Loss mitigation tool**. Policy pays the cash outlay.
B. **Strategic tool**. Allays concerns and bridges impasses in negotiations. E.g., executives being hired by new company will not be disgruntled employees due to challenge to payments made to them as a part of the transaction.
C. **Reasonably priced and conditioned device**. Generally, the premium, expressed as a percentage of the policy limits, is in the range of 4% to 7% (pennies on the dollar). Few exclusions and plain language wording available.
D. **Speed and flexibility**. "Eleventh hour" discoveries will not necessarily delay the closing if information is provided to the underwriter. Submission generally requires a phone call, followed by a copy of the M&A agreement, deferred compensation plan and last audited financial statement.

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