# Fear & Loathing in Code Sec. 409A

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As we enter the post-election and current economic malaise, M&A TAX REPORT readers are no doubt braced for a new raft of tax bills. These tax bills, like those of the recent past, are apt to have vainglorious names. Although I recognize that sometimes something is what you call it, I still wish we could have tax acts that were titled like tax acts. What is wrong with calling something the "Tax Reform Act of [BLANK]?"

In 2004, the *nom de plume* was the American Jobs Creation Act of 2004, which, by the way, despite its feel good name, included within it a number of tax *increases.* One increase came in the form of heightened scrutiny (and just plain disallowance) to a number of relatively tried and true deferred compensation arrangements. Think 409A.

With the enactment of new Code Sec. 409A, a cynic might say that the Internal Revenue Code has become such a behemoth that we must now resort to letters as well as numbers. Of course, a cynic might also say that Code Sec. 409A helped the law that enacted it live up to the name hype of the Jobs Act. If nothing else, the Jobs Act certainly led to job creation in executive compensation consultants, tax lawyers and accountants in that field.

## Big Job

At its root, Code Sec. 409A provides that amounts deferred under a nonqualified deferred compensation plan must be currently included in gross income if they are not subject to a substantial risk of forfeiture, and have not previously been included in gross income. That sounds harsh. Yet, there is a large "but" that allows you to meet certain requirements to fall *outside* this harsh rule, and back into what one would think of as traditional (pre–Jobs Act) deferred compensation rules.

The current *lingua franca* holds that 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. One of the initial stumbling blocks about the scope of this provision is just what constitutes a "plan."

The following types of arrangements and agreements are among the many types of arrangements that are covered by the broad (and some might say grasping) reach of Code Sec. 409A:

- Any employment, bonus or compensation agreement (even if it covers only one employee!) that results in the deferral of the taxation of compensation
- Supplemental executive retirement plans (sometimes called SERPs), and other nonqualified retirement arrangements
- Restricted stock, phantom stock and performance share plans
- Code Sec. 457f plans
- Certain stock appreciation rights
- Many long-term or multi-year bonus or commission programs

One might assume from the expansiveness of this list that caution is appropriate. Talk about understatement. In fact, the expansiveness may cause you to want to assume that virtually any kind of deferred compensation arrangement will be within the scope of Code Sec. 409A. Change in control agreements, severance agreements, employment agreements, agreements covering the delayed payout of option proceeds, *etc.,* can all be brought within the reach of this provision.

## Acquisition Jitters

If you have not considered some of these issues before, you are likely to consider them when you ask a potential target company to produce copies of all nonqualified deferred compensation plans and agreements. On a very fundamental level, if you are a buyer, for tax as well as nontax reasons, you want to know about everything. If you are a seller, you have a schizophrenic reaction.

Although in some respects you may want to disclose everything, you also want to respond only to what's being requested, and not to complicate things more than they need to be complicated.

In this context, many a target company is likely to think that a contract or "plan" that benefits only one executive or perhaps only a few high management personnel might be outside the scope of such a boilerplate request. In some cases, target counsel are now becoming more specific, asking for information and documentation regarding all nonqualified deferred compensation plans within the meaning of Code Sec. 409A.

Here, one must separate public companies from private companies, since Code Sec. 409A has even longer teeth when it comes to the operations of publicly held entities. As but one example, there is a six-month delay rule in the case of distributions to certain employees. In general, these include key employees from publicly held corporations. Because of the presence of such rules, one should consider a matrix of queries for public to public company acquisitions, public to private acquisitions, and private to public acquisitions.

## Options

There has long been confusion about the respects in which stock options are subject to the Code Sec. 409A regime. In general, the following types of stock options are treated as nonqualified deferred compensation under Code Sec. 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:

- Options granted and vested before January 1, 2005, if they were materially modified on or after October 3, 2004
- Options granted before January 1, 2005, but that were not fully vested as of January 1, 2005 (provided that Code Sec. 409A will apply only to the unvested portion of the option)
- Options granted on or after January 1, 2005

The big point about options, of course, is that Code Sec. 409A rules are triggered dependent upon whether the option was granted with an exercise price equal to or greater than fair market value. That may mean that it's relatively easy to plan around the applicability of Code Sec. 409A with stock options. Yet, from a due diligence perspective, it means the buyer is going to have to carefully review the target's option practices, including resolutions and specific option grants, to verify pricing.

It also means there should be significant scrutiny given to whether there has been a "material modification" of the options. A material modification generally means the material enhancement of a benefit or right existing as of October 3, 2004, or the addition of a new material benefit or right that affects the amount earned and vested before January 1, 2005.

Regardless of what the plans may say, part of the negotiation dynamic in an acquisition can include acceleration of option vesting, and cashing out options on closing. This certainly goes beyond the due diligence function, and has significant traps.

For example, if the options were discounted (granted at less than fair market value), and the options are accelerated as to vesting or payment of cash to optionees in connection with the termination of the options, Code Sec. 409A may subject the optionee to taxation.

## Other Equity

Apart from stock options, other equity granting policies should be reviewed too. As with stock options, the key issue is going to be the extent to which options or equity are granted based on an exercise price that is equal to or greater than fair market value versus a discount. One can stumble into Code Sec. 409A applicability, however, with deferral features on equity issuances.

## Severance and Employment Agreements

Although it is not exactly a due diligence function, any consideration of severance agreements or employment agreements for the employees of the target should consider Code Sec. 409A implications. Perhaps the most obvious point here is that any such agreement may be written as an attempt to make a target employee whole, as by offering replacement money or consideration for some kind of deferred compensation benefit that is not going to be available.

This is important, since entitlement or payment of benefits that act as a substitute for (or replacement of) amounts considered to be deferred compensation under a plan can also be viewed as subject to Code Sec. 409A. In appropriate cases, the right to the new payment or new agreement can be considered an impermissible acceleration of payment of the forfeited deferred compensation.

## Scratching the Surface

As this abbreviated discussion should indicate, it only scratches the surface of the potential impact of Code Sec. 409A on acquisitions. The implications of Code Sec. 409A on even the most straightforward of acquisitions can be significant and even Byzantine. The sooner one recognizes such issues in the process, the better.