Getting Specific About 409A's Specified Employees to Take Effect April 1, 2009

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Overview

Public companies with deferred compensation arrangements need to be aware of and comply with certain requirements under the tax laws that apply when making payments to certain key employees when those employees separate from service with the company. Specifically, Section 409A of the Internal Revenue Code of 1986, as amended (the "Code") requires a delay of six months in paying any deferred compensation to a "specified employee" of a public company after and on account of a separation from service. (For this purpose, "deferred compensation" can include some severance and other post-employment payments that are not exempt from 409A as well as more traditional deferred compensation arrangements.) Public companies must understand how and when to identify specified employees in accordance with Section 409A. In addition, deferred compensation plans and arrangements covering specified employees must, at a minimum, contain provisions requiring the six month delay, preferably in the terms of any plan or arrangement that might have the issue–the deadline for having the language in place for a particular employee is when he or she becomes a specified employee. Most public companies will need to update their lists of specified employees to take effect April 1, 2009 for the following 12 months.

Which Companies are Covered?

While Section 409A applies to private and public companies, the "specified employee" rules apply only to public companies and their subsidiaries and other affiliates. The public company definition reaches beyond U.S. stock exchanges such as the New York Stock Exchange and interdealer quotation systems such as Nasdaq to include companies who trade on non-U.S. exchanges (such as the London Stock Exchange) that are officially recognized, sanctioned or supervised by a governmental authority. This means that publicly traded foreign corporations that employ U.S. taxpayers or that have subsidiaries with U.S. taxpayer employees also have to be concerned about the "specified employee" rules and the six month delay.

Who are the Specified Employees?

Whether someone is a specified employee depends upon his or her status during the 12-month period ending on the "specified employee identification date." Someone who was a "key employee" of the public company or of its subsidiaries or affiliates during that 12 month period will be potentially subject to the six month payment delay on separation from service.

Key Employee. A "key employee" for this purpose is an employee who, at any time during the 12 month period described above, is (i) an officer of the public company or its affiliates who has annual compensation greater than $160,000 (as indexed for inflation in 2009 ($150,000 in 2008)), (ii) a 5% owner of such company, or (iii) a 1% owner of such company and who has an annual compensation of more than $150,000 (which is not indexed for inflation). Employers have some latitude in determining what constitutes "compensation" for this purpose, as long as they are consistent in the use of the definition. One typical definition would use the compensation as measured for the company's 401(k), assuming the company is using a safe harbor definition, but without regard to the limits that apply to 401(k) contributions. If the employer does not specifically select a different definition of compensation, the default rule will include forms of compensation that may vary from year to year for reasons outside the employer's control, such as the exercise of options or the vesting of restricted stock.

Officer. The "key employee" definition uses the nebulous term "officer," which the tax regulations define as an administrative executive who is in regular and continued service with the employer. Whether an employee qualifies as an officer is fact-based and includes considerations such as the source of the employee's authority, the term of election or appointment, and the nature and extent of his or her duties. An employee who merely has the title of an officer, but not the authority of an officer, is not considered an officer for purposes of the key employee test. Conversely, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of this test. The rules provide numerical limits on the number of officers, although some companies will have fewer than the limit. For employers with more than 500 employees, no more than 50 employees will be specified employees. For employers with 500 or fewer employees but more than 30 employees, no more than 10% of all employees will be specified employees (rounded up to the nearest whole number). For employers with 30 or fewer employees, no more than three employees will be specified employees. (For purposes of determining the number of employees, the rules require looking at all the affiliated entities and determining the highest number of employees they had collectively in the current and four preceding years.) These numerical limits can be quite important for smaller or newer public companies, who may find that they do not have to include all of their senior officers on the list. The determination of whether someone is an officer is made with respect to that individual's employing entity and not with respect to the whole group of companies. Note that while ordinarily all Section 16 officers will be "officers" for purposes of this test, the tax rules reach more broadly than Section 16's definition.

When is the Status Determined and How Long Does it Last?

Identification Date. Each employer must identify which employees are specified employees for purposes of Section 409A on a designated date each year (the "Identification Date"). The default Identification Date is December 31 (without regard to the employer's fiscal year); however, an employer may designate any other date as the Identification Date as long as the employer uses the same Identification Date with respect to all nonqualified deferred compensation plans. Once the Identification Date has been designated for a given year, any subsequent change to the Identification Date will not take effect for at least 12 months after the decision to change the date has been made.

Effective Date. After an employer has designated an Identification Date, the employer must choose a date on which the identified employees become specified employees for purposes of applying the six-month delay rule. The default "Effective Date" is the first day of the fourth month following the Identification Date; however, the employer may designate an alternative date as long as such date is no later than the first day of the fourth month following the Identification Date and the employer uses the same Effective Date with respect to all nonqualified deferred compensation plans. As with the Identification Date, once the Effective Date has been designated for a given year, any subsequent change to the Effective Date will not take effect for at least 12 months after the decision to change the date has been made.

For employers who have not yet taken any action with respect to choosing these dates, the Identification Date will be December 31 and the Effective Date will be April 1. We recommend that employers who do not currently maintain a list of specified employees should promptly commit to writing the process used to identify specified employees prior to the Identification Date and then create the list itself. As described above, the employer may change these dates, but for the 12-month period beginning on the date the employer decides to change the dates, the Identification Date and Effective Date will remain December 31 and April 1, respectively.

Alternative Method. Instead of adopting the method outlined above for determining which employees are specified employees, an employer may develop its own method for identifying specified employees, provided that the alternative method (i) is reasonably designed to include all specified employees, (ii) is an objectively determinable standard providing no direct or indirect election to any employee regarding its application and (iii) results in either all employees or no more than 200 employees being identified as a class as of any date.

Special Situations. The Section 409A rules also provides some special rules with respect to the treatment of employees in connection with mergers, spinoffs, and initial public offerings. In addition, they provide principles for treatment of non-U.S. taxpayers when compiling the lists of specified employees, and employers with non-U.S. operations will want to consider whether and how to count the non-U.S. employees in compiling the list of specified employees.

Case Study. Pubco and its subsidiaries had 250 employees during 2008 and had not employed more people in any of the preceding four years. None of the employees owned at least 1% of any of the entities. The pool of potential specified employees would be the lesser of the total number of persons fitting the definition of "officer" at any point in 2008 and 25 (10% of 250), where the 25 are ranked by compensation. After applying that ranking, Pubco determined that, for the year ended 2008, the top 25 officers included all of its Section 16 officers, some of its executive officers, and several senior executives at its subsidiaries. Everyone on that list as of December 31, 2008 will appear on the list of "specified employees" effective April 1, 2009 even if he or she has been demoted since the end of 2008 and will remain on the list until March 31, 2010. Anyone on the list as of April 1, 2008 who does not satisfy the criteria as of December 31, 2008 leaves the list as of April 1, 2009.

Why Does this Matter?

As mentioned above, the payment of nonqualified deferred compensation to an individual who is designated as a specified employee may be subject to a six month delay following his or her separation from service. An arrangement that provides for installment or annuity distributions upon an employee's separation from service meets this requirement either by delaying the commencement of such payment for six months or by making a catch-up distribution of the first six months of payments at the beginning of the seventh month following the separation of service.

Section 409A requires the six month delay rule to be written in a plan or agreement that provides for distributions upon a separation from service. Additionally, the provision must be set forth in writing on or before the date an employee becomes a specified employee. Therefore, we recommend adding the six-month delay rule to all plans and arrangements providing post-separation from service payments, regardless of whether the recipient of such payments has been designated as a specified employee.

Failing to comply with the six month rule or the written documentation rule can subject the "specified employees" to the adverse tax treatment of Section 409A, including the potential for accelerated taxation, 20% penalties (or 40% in California), and enhanced interest penalties.

There are a number of ways to structure nonqualified deferred compensation arrangements to avoid the imposition of the six-month delay rule on specified employees. If you have any questions on the specified employee determination process, the six-month delay rule or with respect to drafting your compensation plans and arrangements to comply with Section 409A, please contact us.

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