

# The New Standard for Deferred Compensation

## *IRC Section 409A: Are Your Compensation Practices Causing Risk?*

Internal Revenue Code 409A has been described as “the ERISA of employee and executive compensation,” making it an important issue for CFOs, CEOs, Board Members, Venture Investors, Human Resource Directors, Corporate Attorneys, and, of course, employees.

While the new code has implications for both public and private companies, it may be particularly threatening to privately held companies. Failing to comply could cause major financial hardship for the very employees your organization has fought hard to recruit, retain and reward.

### WHAT IS IRC 409A?

In the wake of corporate scandals that saw highly-paid executives receive deferred compensation payments while rank and file employees lost their retirement savings, Congress enacted Internal Revenue Code “Section 409A” to curb such abusive practices.

The new law requires compliance with numerous and complex regulations in order for deferred compensation arrangements (other than tax-qualified retirement plans) to maintain preferential tax treatment.

### WHAT'S THE RISK OF NOT COMPLYING?

Potential adverse tax consequences for the compensated person include:

- an immediate and retroactive tax assessment
- a 20% penalty levy
- interest charges from the vesting date

These tax exposures could easily exceed two-thirds of a deferred compensation benefit not yet received in cash, producing financial hardship for the employee and creating a major employee relations problem for the organization. In addition, the employer has tax withholding and reporting obligations for Section 409A violations. It is logical to expect lawsuits from a employees who suffer from noncompliance attributable to an employer's mistake.

### WHAT TYPE OF COMPENSATION IS INVOLVED?

The new rules apply to any deferred compensation earned and vested under a “nonqualified deferred compensation plan” after December 31, 2004. In addition to traditional elective deferral plans and SERPs, Section 409A can cover many arrangements that would not normally be considered “nonqualified deferred compensation,” such as:

- stock options and other forms of equity compensation
- severance agreements
- bonus plans
- post-retirement reimbursements

409A applies to employees, partners and contractors, regardless of compensation level.

### DOES 409A IMPACT STOCK OPTIONS?

The good news is stock options can be structured to be exempt. IRS proposed regulations provide an exemption for a stock option if its exercise price is at least equal to the “fair market value” of the option property on the grant date and the option property is so-called “service recipient stock.” Private companies will be especially impacted by this. Some of the issues include:

- Private companies may be unable to rely on the most recent funding event to establish stock values for option grants
- A 409A stock valuation differs significantly from a typical enterprise valuation because it requires modeling of the capital structure and allocation of the total enterprise value to common stock
- Advice from an independent, professional stock valuation expert may be needed to substantiate valuation assumptions for tax and reporting purposes
- Preferred stock and certain classes of common stock will not qualify for the stock option exemption under proposed regulations

**Recommended Response:** Evaluate your stock option granting procedures and take corrective action. The objective is to address any “in the money” options that are not grandfathered before December 31, 2007 (or, in the case of certain “backdated” options, by December 31, 2006) to avoid 409A violations.

#### WHEN DO I HAVE TO COMPLY WITH 409A?

Section 409A is effective now. Any compensation earned or vested after December 31, 2004 must comply in operation. Currently IRS transition guidance allows plans to comply in practice using a “reasonable good faith” interpretation until December 31, 2007. The IRS has announced its intent to issue final regulations under Section 409A in 2006, after which all plans will be required to be amended for compliance by December 31, 2007. Remember that compensation deferred under plans that are non-compliant, in either operation or form, is subject to substantial tax consequences.

#### WHAT DOES MY COMPANY NEED TO DO TO BE COMPLIANT?

Seek advice from qualified tax, legal, and valuation professionals to assist with six steps:

1. Familiarize yourself with Section 409A immediately, given the risks.
2. Identify all arrangements that may be subject to Section 409A. It may be possible to exempt some of these arrangements.
3. Determine the changes that are necessary in order to comply - several approaches are available in some areas.
4. Avoid taking actions that would result in loss of grandfather status for benefits that were earned and vested before 2005.
5. Communicate changes to all employees – certain changes may require their consent.
6. Amend plan documents.

#### A BRIEF CASE STUDY

A successful, growing, and profitable private equity-backed member loyalty and financial services company regularly used common stock options as an element of key employee compensation and retention. This was an important factor in light of the investors’ eagerness for a liquidity event in sometime in 2006. Historically options grants were valued using internally-developed models and staff.

In light of 409A, the company sought legal and tax advice before the 2006 option grants cycle. Valuations were performed both internally and by outside professionals. Three months later, the company was sold at a premium above the prior valuation results. Had the company continued with only an internal valuation, the 2006 option recipient might have faced harsh 409A tax levies. However, the valuation supported by outside professionals meets the “fair market value” test, so the risk was avoided.

#### TAKE CORRECTIVE ACTION NOW

IRC Section 409A is already in effect, so taking immediate action to review your deferred compensation arrangements will minimize the risk of accidental adverse tax consequences. Contact the authors today through the emails listed below with any questions that you may have.

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