Specified Employees Under IRC Section 409A

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This Note provides an overview of the methods for determining specified employees under IRC section 409A for purposes of applying the six-month delay to payments on separation from service from nonqualified deferred compensation plans.

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Section 409A of the Internal Revenue Code and its related regulations (Section 409A), enacted as part of the American Jobs Creation Act of 2004, P.L. 108-357, regulate the time and form of payment under nonqualified deferred compensation plans. Not only are traditional nonqualified deferred compensation plans such as supplemental executive retirement plans affected, Section 409A also governs many plans that are not ordinarily considered deferred compensation, such as bonus plans, discount stock options, and even severance and employment agreements. Under Section 409A, elections for deferring compensation must be in writing and made within specific time periods, generally in the year before the year in which the compensation is earned. In addition, the deferred compensation may only be paid out on the events permitted by Section 409A, such as disability, death, change in control, separation from service and unforeseeable emergency.

Section 409A provides that an employer that has any outstanding stock that is publicly traded on an established securities market may not pay any deferred compensation to a "specified employee" until six months after the specified employee incurs a separation from service. The restriction applies only to payments that are actually triggered by the separation from service. If an employee elected a specific payment date, or if a payment is triggered by an event other than separation from service (that is, disability, death, change in control or due to an unforeseeable emergency), the six-month delay does not apply.

Generally, failure to comply with the Section 409A rules results in severe consequences for the affected employee, not the employer:

- Compensation under the non-compliant arrangement (and any similar arrangements that must be aggregated with it) is included in income.
- A 20% excise tax is imposed on the amount involved.
- An increased interest rate is imposed on the late payment of the income tax due on the compensation.

The IRS has set up correction procedures for payments that inadvertently violate the six-month rule. The correction procedures generally require the specified employee to repay the premature distribution, and then impose an additional waiting period before the payment may be paid. An attachment to both the employer's and the employee's tax returns is also required (see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Reporting Operational Failures (www.practicallaw.com/6-501-2009)*).

This Note explains how to determine an employer's specified employees and identifies optional provisions designed to assist employers in tailoring the determination to their particular business needs.

An outline of the steps taken for determining specified employees can be found in *Determining Specified Employees under Section 409A Checklist (www.practicallaw.com/3-501-1332)*.

See also, *Practice Note, Section 409A: Deferred Compensation Tax Rules (www.practicallaw.com/6-501-2009)*.

PUBLICLY TRADED ON AN ESTABLISHED SECURITIES MARKET

The six-month delay in payments only applies to specified employees of employers whose stock is publicly traded on an established securities market. A securities market includes national and foreign national securities exchanges supervised by a governmental authority, as well as American depositary receipts in the US.

The six-month delay applies to employers on a controlled group basis. Therefore even if a multinational employer is publicly traded only on a non-US stock exchange, the employer must still identify its specified employees. The determination of whether entities are part of the same controlled group is governed by IRC Section 414, a full explanation of which is beyond the scope of this Note. Typically, a controlled group includes all 80% owned subsidiaries of a parent corporation, so an 80% owned US subsidiary of a publicly traded foreign parent is subject to the six-month delay.

GENERAL RULE FOR DETERMINING SPECIFIED EMPLOYEES

Under Section 409A, an individual who is a specified employee (see *Specified Employee*) at any time during the 12-month period ending on the "specified employee identification date" (see *Specified Employee Identification Date*) is treated as a specified employee for the entire 12-month period beginning on the "specified employee effective date" (see *Specified Employee Effective Date*). Employers must use these dates to create their specified employee lists for each 12-month period. Individuals who are new specified employees on the specified employee identification date and who terminate employment before the specified employee effective date technically are not specified employees and not subject to the six-month delay.

SPECIFIED EMPLOYEE

The term "specified employee" includes:

- Any employee who owned more than 5% of the stock of the company at any time during the year.
- Any employee who owned more than 1% of the stock of the company at any time during the year and received annual compensation greater than $150,000.
- The 50 most highly compensated officers (see *Officer*) of the employer, provided that their compensation (see *Compensation Used in Determination*) is greater than the indexed threshold amount of $160,000 (in 2010).

Number of Officers

No more than 50 officers must be identified. However, if the employer (including all members of its controlled group) has fewer than 491 employees, the maximum number of officers that must be identified is limited to the greater of 10% of employees, rounded to the next higher integer, or three officers. For example, an employer with 472 employees must only identify 48 officers.

The following employees are excluded in determining the number of total employees for purposes of the 10% test:

- Employees with less than six months of service.
- Employees who work less than 17.5 hours per week.
- Employees who are under the age of 21.
- Employees who do not work more than six months per year.

Officers who are specified employees because of their stock ownership are excluded in determining the 50 most highly compensated officers.

There is no minimum number of officers that must be considered. If the company has fewer than 50 officers, only the employees who are officers are subject to the six-month delay. However, the definition of officer for this purpose is much broader than the corporate or securities law definition (see *Officer*).

Officer

In determining the 50 most highly compensated officers, the term "officer" is not limited to corporate officers, but includes any employee who has significant administrative or policy-making responsibility.

The determination is based on all the facts, including the:

- Source of the employee's authority.
- Term for which the employee was elected or appointed.
- Nature and extent of the employee's duties.

An employee who merely has the title of an officer but not the authority is not considered an officer. Similarly, an employee who does not have an officer title but does have the authority of an officer is considered an officer regardless of title. Therefore vice presidents, and even directors or managers, who are normally not considered officers for corporate purposes, may be considered officers under Section 409A.

Compensation Used in Determination

"Compensation" for purposes of identifying the top 50 officers has a specialized meaning under Section 409A (see *Compensation Used to Determine Specified Employees Checklist (www.practicallaw.com/7-501-1325)*).

However, employers can use a simplified definition, provided that the simplified definition is included in the applicable agreement or plan and is applied consistently to all employees. For most employers, total W-2 compensation, plus elective 401(k) and cafeteria plan deferrals, is the easiest definition of compensation to determine. The principal distinction between W-2 compensation and the 409A default definition is that taxable income recognized on the exercise of nonqualified options or the vesting of restricted stock, and payments of nonqualified deferred compensation, are not included in the default definition. However, because W-2 compensation includes these types of income, compensation levels can vary dramatically from year to year and can significantly affect the order of the most highly ranked officers in terms of compensation.

Exclusion of Non-US Taxpayers

The Section 409A general rule requires that all employees be included regardless of whether they are US taxpayers covered by Section 409A. This requires employers to determine what the non-US taxpayer employees' income would be under US tax rules and then convert it into dollars. In some cases, it may be difficult for an employer to collect global compensation data and in some circumstances, local privacy laws may prevent collecting it entirely. Due to these complexities, many multinational employers take advantage of an optional provision that allows employers to exclude certain (non-US) foreign compensation earned by nonresident aliens. This exclusion, if elected, essentially limits the specified employees to US taxpayer employees, thus increasing the number of US taxpayer employees who are subject to the six-month delay.

Even if the company elects to exclude non-US employees for this purpose, the non-US employees still must be counted in determining the total number of employees for purposes of the 10% test (see *Number of Officers*).

For the procedures for electing to exclude certain non-US foreign compensation see *Documenting Optional Provisions*.

SPECIFIED EMPLOYEE IDENTIFICATION DATE

Under Section 409A, the default specified employee identification date is December 31. The employer may choose another identification date in accordance with Section 409A if the date is the same for all of the employer's nonqualified deferred compensation plans. The specified employee identification date may be changed, but the new date may not take effect for 12 months.

SPECIFIED EMPLOYEE EFFECTIVE DATE

Under Section 409A, the list of specified employees becomes effective on the first day of the fourth month following the specified employee identification date. For example, if the specified employee identification date is December 31, 2009, the specified employee effective date is April 1, 2010 under the default rule.

However, the employer may specify an earlier specified employee effective date in accordance with Section 409A. Many employers prefer to use February 1, particularly if they are using W-2 compensation to compile the list (see *Compensation Used in Determination*). The specified employee effective date must be the same for all of the employer's nonqualified deferred compensation plans. The specified employee effective date may be changed, but the new date may not take effect for 12 months.

The six-month delay for specified employees only applies where the employee is actually a specified employee on the date of separation from service. If the specified employee list on which an employee appears is not yet effective, the employee is not considered a specified employee subject to the six-month delay, unless the employee appears on the current list.

For example, assuming the employer uses April 1 as its specified employee effective date, an employee who was one of the 50 most highly compensated officers for 2009 (but not for 2008) will become a specified employee on April 1, 2010, and will be subject to the six-month delay if his employment is terminated any time between April 1, 2010, and March 31, 2011 (even if he is not one of the most highly compensated officers for 2010).

CORPORATE TRANSACTIONS

Section 409A also outlines the method for calculating the 50 most highly compensated officers in the context of different types of corporate transactions:

- **Merger of two public companies.** The surviving or acquiring company uses its own specified employee identification and effective dates. From the date of the transaction to its next specified employee effective date, the specified employee lists of both entities are combined to form one list. The top 50 officers of the combined list, ranked by compensation, as well as any 1% and 5% owners (see Specified Employee) who are not also one of the top 50 officers, are considered the surviving or acquiring company's specified employees. When the next specified employee effective date occurs, the list is revised based on the owners and officers of the combined entity. As an alternative, the surviving company may elect any other reasonable method for determining specified employees, if the election is made within 90 days of the transaction and the method applies only prospectively from the date of its adoption.

- **Merger or acquisition involving a non-public company and a public company.** The specified employees of the public company will continue to be the specified employees until the first specified employee effective date after the transaction. The employees of the private company are not included on the list until the next specified employee effective date.

- **Spin-off.** When a company is spun off from a public company and remains a public company, the specified employees continue to have that status until the next specified employee effective date. The specified employee identification and effective dates in effect pre-spin-off continue for both the original company and the spun-off company until changed.

- **Initial public offerings.** A company that becomes publicly traded automatically has a specified employee identification date of the December 31 and a specified employee effective date of the April 1 preceding the offering. These dates are used to determine the specified employees for the period beginning on the date of the offering to the next December 31. As an alternative, the company may elect different specified employee identification and effective dates if the dates chosen occur on or before the date of the offering.

DOCUMENTING OPTIONAL PROVISIONS

Section 409A permits the employer to adopt a number of optional provisions in identifying the specified employees and applying the six-month delay. Most of these optional provisions must be contained in the applicable plan or agreement and must be applied consistently to all of the employer's deferred compensation plans. Some employers do this through a Specified Employee Policy that sets out the elections the company has made for how specified employees are determined. The Specified Employee Policy should include the specified employee identification and effective dates, and clear guidelines about any other issues specific to the company's circumstances that would affect specified employee determinations. This can also be accomplished by a resolution adopted by the compensation committee if the elections are binding on all applicable plans and agreements.

ALTERNATIVE METHOD FOR DETERMINING SPECIFIED EMPLOYEES

As an alternative to the general rule (see *General Rule for Determining Specified Employees*), an employer may choose an alternative method to identify employees who will be subject to the six-month delay provided that the alternative method:

- Is reasonably designed to include all specified employees.

- Is objectively determinable and does not allow any employee to directly or indirectly manipulate the method.

- Results in either all employees or no more than 200 employees being identified as specified employees.

For example, a large company could determine that a list of the 100 most highly compensated employees is reasonably anticipated to include the 50 most highly compensated officers and the more than 1% and 5% employee-owners.

ALTERNATIVE METHODS FOR IMPOSING SIX-MONTH DELAY

To ease the administrative burden of determining specified employees, some employers design their deferred compensation plans to delay all payments by six months, regardless of whether an employee is a specified employee. This is the safest and easiest manner of complying with the six-month delay requirement, but may result in resistance from employees, at least as applied to a broad-based deferred compensation plan. However, in drafting the employment agreement of an executive who is likely to always be a specified employee, this is often the simplest approach.

A variation of this technique is to impose the six-month delay on all employees who earn more than the threshold amount, without regard to whether they are officers. Because this would include most employees who participate in deferred compensation plans, however, it is also likely to meet with employee resistance.

Amending an existing deferred compensation plan to impose the six-month delay on all participants, whether or not they are specified employees, is considered a re-deferral, and is prohibited unless the amendment is adopted at least 12 months before termination of employment and the payment date is deferred to at least five years after termination of employment.

More information can be found in:

Standard Document, Section 409A: Explanatory Memorandum for Directors/Compensation Committee (www.practicallaw.com/5-501-2364).