Section 409A Update: Why Companies that Missed the March 15 Payment Deadline May Not Have Violated Section 409A

March 15, 2009 was the payment deadline for many annual bonuses earned with respect to calendar year 2008 that were intended to satisfy the “short-term deferral” exemption under Internal Revenue Code (Code) Section 409A. The short-term deferral exemption generally provides that compensation will not be treated as deferred compensation, even if it is not paid in the year in which it is earned, so long as it is paid on or before the 15th day of the third month of the year following the year in which the employee’s right to the compensation vests. Because many employers with calendar fiscal years structure bonus arrangements with the intent to rely on this exemption, bonuses that were not paid by March 15 risk failing to be exempt from or compliant with Section 409A, and as a result may be subject to significant additional income taxes. Fortunately, even if a bonus was not paid by March 15, the terms of the bonus arrangement may permit the bonus to be treated as compensation that is exempt from Section 409A, or as deferred compensation that complies with Section 409A.

Below are several analytical approaches that may prevent 2008 bonuses paid after March 15, 2009 from violating Section 409A.

No Legally Binding Right. Section 409A applies only to deferred compensation, which generally is defined as compensation that is or may be payable later than the year in which the legally binding right to the compensation arises. Consequently, if the employee did not have a legally binding right to the bonus during 2008, the failure to pay the bonus on or before March 15 should not result in a violation of Section 409A. An employee generally will not be treated as having a legally binding right to a bonus if the employer may unilaterally reduce or eliminate the bonus, or if the bonus otherwise is discretionary. Whether a bonus is truly discretionary requires an analysis of all of the facts and circumstances, including the employer’s past practices, written bonus documentation, and other written and unwritten terms of the bonus arrangement.

Substantial Risk of Forfeiture. Where the employee has a legally binding right to the bonus, the failure to pay the bonus by March 15 should not result in a violation of Section 409A if the employee’s right to the bonus remains subject to a substantial risk of forfeiture (SROF), such as a requirement that the employee remain employed through the payment date. For example, if continued employment is required or another SROF applies beyond December 31, 2008, then March 15, 2009 is not the applicable short-term deferral deadline for the bonus. Consequently, payment of the bonus later in 2009 (or even as late as March 15, 2010) should still satisfy the short-term deferral exemption. If, however, the bonus arrangement provides that the employee’s right to the bonus is conditioned on employment through December 31, 2008, and the bonus is not subject to another SROF extending beyond December 31, 2008, then the bonus is no longer subject to a SROF and the failure to pay on or before March 15, 2009 generally will preclude the use of the short-term deferral exemption. If no other exemption applies, such a bonus therefore must comply with Section 409A in order to avoid adverse tax consequences.

Compliance with Section 409A. If the employee has a legally binding right to the bonus and the right became vested (i.e., no longer subject to a SROF) on or before December 31, 2008, the bonus may still comply with Section 409A. A bonus should comply with Section 409A if the bonus plan or agreement expressly provides that the bonus will be paid on a specified date (or during a specified calendar year), or upon other permitted Section 409A payment events, and if it is, in fact, paid in
In accordance with the plan or agreement. In addition, under a special Section 409A rule, a bonus will be treated as having been paid on the date specified if it is paid on any later date in the same calendar year. Therefore, if the bonus arrangement provides that the bonus will be paid during 2009, the bonus should comply with Section 409A so long as the employer does, in fact, pay the bonus during 2009. However, if the bonus arrangement is silent or ambiguous with respect to the timing of payment, the arrangement may fail to comply with Section 409A and the bonus may be subject to adverse tax consequences under Section 409A.

Other Possibilities. The payment of the bonus after March 15 nonetheless may satisfy the short-term deferral exemption if: (1) it was administratively impracticable to make the payment on or before March 15 (and such impracticability was not foreseeable), or (2) making the payment by the March 15 deadline would have jeopardized the employer’s ability to continue as a going concern, provided that the payment is made promptly after payment is no longer administratively impracticable or will not longer jeopardize the employer as a going concern. Also, the payment of the bonus after March 15 may satisfy the short-term deferral exemption if the employer reasonably anticipates that its deduction of the bonus will be subject to the $1 million deduction limit under Code Section 162(m) (and the employer did not reasonably anticipate the application of Section 162(m) when the bonus award was originally made), provided that the bonus is paid promptly after the employer reasonably anticipates that the bonus is no longer subject to Section 162(m) deduction disallowance.

Latham & Watkins will continue to monitor developments regarding the bonus tax legislation as they occur. Please feel free to contact David Barby at +1.714.540.1235, David Taub at +1.213.485.1234, Sara Richland at +213.485.1234 or any of the attorneys listed below if we can be of assistance.

Abu Dhabi
Bryant B. Edwards
+971.2.672.5002

Los Angeles
James D. C. Barrall
David M. Taub
Joseph B. Farrell
+1.213.485.1234

Rome
Fabio Coppola
+39.06.9895.6700

Barcelona
Jordi Domínguez
+34.93.545.5000

Madrid
Jordi Domínguez
+34.91.791.5000

San Diego
Holly M. Bauer
+1.619.236.1234

Brussels
Howard Rosenblatt
+32.2.788.60.00

Milan
Fabio Coppola
+39.02.3046.2000

San Francisco
Scott D. Thompson
Linda M. Inscoe
+1.415.391.0600

Chicago
Robin L. Struve
Sandhya P. Chandrasekhar
+1.312.876.7700

Moscow
Mark M. Banovich
+7.495.785.1234

Shanghai
Rowland Cheng
+86.21.6101.6000

Doha
Bryant B. Edwards
+974.452.8322

Munich
Claudia Heins
+49.89.2080.3.8000

Silicon Valley
Joseph M. Yaffe
Jeffrey R. II
+1.650.328.4600

Dubai
Bryant B. Edwards
+971.4.704.6300

New Jersey
David J. McLean
+1.973.639.1234

Singapore
Mark A. Nelson
+65.6536.1161

Frankfurt
Hans-Jürgen Lütt

New York
Jed W. Brickner

Tokyo
Hisao Hirose
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