Bloomberg Tax

Daily Tax Report®



# INSIGHT: Sting of Deferred Compensation Tax—Is There Any Recourse Against Employer

**By Daniel L. Morgan**
**Blank Rome LLP**

Section 409A was added to the Tax Code in 2004 to, among other things, limit the ability of companies and their executives to optimize tax outcomes by controlling the timing of deferred compensation payments. Although this article focuses on executives, Section 409A applies to deferred compensation payable to all employees, as well, in many instances, to deferred compensation payable to independent contractors.

Section 409A is applicable to compensation that is deferred at the election of an executive and to compensation that is deferred by an executive's employer. The reach of Section 409A extends not only to cash payments to be made in the future, but also to certain compensatory equity grants, which may be received or exercised in a later year.

## The Perils of Section 409A

Section 409A is the subject of lengthy regulations, which set forth complex, and in many instances counter-intuitive, rules and exceptions. The regulations require a written document that specifies the amount and timing of an executive's deferred compensation. The regulations also place detailed restrictions on when and how to make or change elections to defer compensation. Failure to follow these rules or qualify for one of Section 409A's exceptions results in harsh tax treatment for the executive who has been promised the deferred compensation, and as written, the regulations produce the same negative tax results for a foot fault as for a material violation. An executive who has a right to receive deferred compensation that the IRS determines does not conform to Section 409A:

- Must include the compensation in income when it is no longer subject to what Section 409A refers to as a ''substantial risk of forfeiture,'' or in more common parlance, at the time the deferred compensation vests, as opposed to when the executive is entitled to receive the compensation.
- Must pay, in addition to income taxes, a 20% additional tax on the value of the deferred compensation, as the compensation vests.
- Must pay a premium interest tax on the compensation.

Promises to provide deferred compensation are typically evidenced in a document prepared and administered by the employer, which as a practical matter means that it is up to the employer to draft a deferred compensation plan or agreement that does not run afoul of Section 409A and to adhere to the terms of that plan or agreement. In the case of elective deferred compensation, the employer must manage an executive's elections in accordance with the requirements of Section 409A.

## Wilson v. Safelite Group Inc.

One of the great oddities of Section 409A is the paradox that, if an employer fails to comply with Section 409A, the brunt of that failure falls on the executive. The recent case of *Wilson v. Safelite Group Inc.* highlights just how painful for an executive this paradox can be. Dan Wilson, who had been the President and Chief Executive Officer of Safelite Group, Inc., elected to defer compensation totaling more than $9 million. According to the Sixth Circuit's opinion and the complaint filed by Wilson, an IRS audit determined that some of Wilson's deferral elections were defective for purposes of Section 409A. Wilson's complaint states that, as a result of the Section 409A violations, he owed income taxes of $2.63 million, a 20% additional tax of $1.47 million, interest of $150,444, and lost investment gains.

Wilson, who was no longer employed by Safelite at the time of the IRS audit, brought an action in federal district court against Safelite, seeking damages from his former employer on the basis of state law claims for breach of contract and negligent misrepresentation. In his complaint, Wilson asserted that Safelite's failure to comply with Section 409A constituted a breach of contract and that Safelite negligently misrepresented to him that he was making his deferral elections correctly.

The federal district court granted Safelite's motion for summary judgment on Wilson's state law claims, concluding that because the plan under which Wilson deferred his compensation was an ''employee benefit pension plan'' subject to the Employee Retirement Income Security Act (ERISA), all of his state law claims were pre-empted. The Sixth Circuit affirmed the district court's decision. For reasons not articulated in the Sixth Circuit's opinion, Wilson chose not to pursue any claims under ERISA.

## What if Wilson's compensation deferrals had been pursuant to a plan that was not subject to ERISA?

Not all promises to pay compensation in the future are governed by ERISA. The distinctions, which were at issue in the *Wilson* case, are technical and beyond the scope of this article, but many deferred bonus and equity or phantom-equity plans or arrangements that are subject to Section 409A are outside the ambit of ERISA. In those instances, an executive's lawsuit against the executive's employer, based upon state law causes of action for damages resulting from an IRS assessment of Section 409A liability, would not be blocked by the preemption argument that prevailed in *Wilson*.

## What if Wilson had sought recovery under ERISA?

ERISA mandates that fiduciaries with respect to an employee benefit plan act in the interest of the plan's participants. A claim by Wilson that the damages he suffered from Safelite's alleged Section 409A missteps resulted from a breach of Safelite's responsibilities to him under the fiduciary duty provisions of ERISA would have required him to successfully assert that the plan under which he had deferred his compensation was not a so-called ''top hat'' plan.

ERISA defines a top hat plan as a plan that is ''unfunded'' and maintained ''primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees,'' and Section 401(a)(1) of ERISA carves out top hat plans from ERISA's fiduciary duty obligations, which means that, if the Safelite deferred compensation plan was a top hat plan, Wilson would have been precluded from arguing that his Section 409A woes arose from a breach by Safelite of its fiduciary responsibilities to him under ERISA.

The Department of Labor has not issued regulations clarifying the contours of what constitutes a top hat plan. Although, most executive deferred compensation plans, to the extent they are not outside the scope of ERISA, would likely be found to be top hat plans, because of the nebulous wording of the statute, the determination of whether a given plan is a top hat plan has been a source of confusion and controversy. For a taste of the interpretative uncertainty engendered by the Department of Labor's lack of guidance, see *Sikora v. UPMC*.

An executive aggrieved by a Section 409A violation, who a court finds was a participant in an ERISA-regulated top hat plan, might nevertheless be able to seek recompense under ERISA by turning to ERISA's enforcement provisions and arguing that the imposition of negative Section 409A tax treatment resulted in a loss of the benefits provided under the plan. Top hat plans are not excepted from ERISA's enforcement provisions.

The leading analogous case is *Davidson v. Henkel*. In *Henkel*, which involved a top hat deferred compensation plan, the plaintiff prevailed on a claim that the employer did not properly administer the plan, resulting in a loss of plan benefits, because the employer did not take into account the value of all of plaintiff's deferred benefits for Social Security (FICA) tax purposes at the time of the plaintiff's retirement. This failure on the part of plaintiff's employer resulted, under the FICA tax regulations, in the plaintiff's benefits being included in FICA tax wages as the benefits were paid, thereby denying the plaintiff the advantage of a single annual FICA tax wage limit for all of his plan benefits, which increased the aggregate amount of FICA taxes the plaintiff had to pay on his benefits. In holding in favor of plaintiff, the court in *Henkel* emphasized that the ''design and purpose'' of the plan was to reduce the plan participants' taxes.

The *Henkel* decision might provide a road map for executives participating in a deferred compensation plan covered by ERISA, who having found themselves on the receiving end of an IRS Section 409A tax assessment, would like to argue that the assessment should be compensated by the executive's employer under ERISA.

As was the case in in *Henkel*, subjecting amounts payable to a participant under a deferred compensation plan to Section 409A taxes reduces the participant's plan benefits. Moreover, it is standard practice for a deferred compensation plan or agreement, in reliance on IRS Notice 2010-6, to include a savings clause, which states that the plan or agreement is intended to be interpreted either to satisfy or be exempt from Section 409A, wording which could be used by an executive, if an employer's action or inaction resulted in a violation of Section 409A, to invoke the reasoning of *Henkel* and show that the employer did not fulfill the intended purpose of the plan.

## Documentary Limitations of Liability

An executive's ability to recover damages for Section 409A taxes under a state law cause of action or under a *Henkel*-themed ERISA lawsuit may be foreclosed by the increasingly common practice of including a provision in a deferred compensation plan or agreement, which states that claims may not be asserted against the employer for Section 409A liabilities. To date, there are no published court opinions discussing whether such limitations of Section 409A liability are enforceable.

As one would expect, most employers are not sympathetic to a request by an executive to remove a Section 409A limitation of liability from an individual agreement with the executive, especially if the executive is represented by counsel who has had an opportunity to review the agreement. That said, because of the anomaly that it is the executive who suffers the Section 409A problems occasioned by an employer's failure to properly administer the agreement, counsel to the executive should consider requesting that the liability limitation not apply to Section 409A taxes that arise by virtue of the employer failing to follow the terms of the agreement.

*This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.*

*Dan Morgan is a partner in the Washington, D.C. office of Blank Rome LLP.*