Section 409A and the Six Month Delay – Don’t Forget Your Directors

By Caroline F. Hayday and Sasha Belinkie on February 8, 2016

It is well known that specified employees of publicly-traded companies must wait at least six months following a separation from service to receive payments of deferred compensation triggered by such separation. The six-month delay requirement must be set forth in the plan establishing the right to the payment of deferred compensation on or before the date the applicable individual first becomes a specified employee. Failure to do so, either as a matter of documentary or operational compliance, could result in the imposition of draconian penalty taxes and interest charges on the service provider under Section 409A of the Internal Revenue Code of 1986 (the “Code”).

What is perhaps less well known is that a non-employee director may also be considered a specified employee. A specified employee is defined by reference to Section 416(i) of the Code and includes “an employee who, at any time during the plan year, is”:

- An officer whose annual compensation is greater than $170,000 (up to the lesser of 10% and 50 employees),
- A 5% owner, or
- A 1% owner receiving annual compensation of more than $150,000.

While there has been some discussion about directors who also hold (formally or informally) an officer position, very little attention has been given to the two ownership prongs of the definition and how they might trigger specified employee status for non-employee directors. On their face the two ownership prongs do not appear to apply to non-employee directors since they simply refer to “employees”; the preamble to the regulations, however, declined to accept the request by certain commenters to limit the universe of specified employees to common law employees. Section 416(i)(3) of the Code provides that self-employed individuals described in Section 401(c)(1) of the Code “shall be treated as an employee,” with Section 401(c)(1) defining a self-employed individual simply as an individual who has earned...
income from self-employment. Since Section 401(c)(1) addresses qualification of retirement plans in which non-employee directors do not commonly participate, the broad definition of employee may not have been focused on non-employee directors, but it does not specifically exclude them from its reach. The Internal Revenue Service generally considers directors fees to be self-employment income (and in fact the proposed Cafeteria Plan Regulations specifically call out directors as being self-employed individuals). Furthermore, Dan Hogans, one of the IRS architects of Section 409A, noted at a 2007 Steptoe & Johnson LLP audio-conference (memorialized in the annotated Section 409A regulations) both that the determination of who is a specified employee is by reference to the top-heavy rules and that directors could be picked up on the basis of share ownership.

Both 1% and 5% ownership of a public company are certainly a significant stake that may be uncommon among non-employee directors, although that level of ownership may be more likely among founders and long-time directors. Companies should also be aware that the ownership need only exceed the requisite threshold at any point in the year and such ownership is determined pursuant to the attribution rules of Section 318 of the Code. Section 318 of the Code sweeps in significantly more than the beneficial ownership rules applicable to public disclosure (e.g., unvested stock options regardless of whether they would vest in the relative short term). These rules may also require attribution of the ownership by partnerships and corporations, relevant for representatives of private equity, hedge fund and venture capital firms who serve on the board of a company in which such a firm holds a stake (although in practice these representatives may not receive compensation for the board service that is settled upon ceasing to be a board member, making designation as a specified employee effectively irrelevant).

Absent additional guidance to the contrary, public companies should consider making sure that their arrangements with their non-employee directors are in documentary compliance on this point, and including non-employee directors in their internal process around determining who their specified employees are and which payments may need to be delayed. For example, many companies provide for director awards that are settled at the time of departure from the board (e.g., restricted stock units that settle upon ceasing to be a board member and deferred fee arrangements) and thus, to the extent the departing director is a specified employee, settlement of those awards would almost certainly need to be delayed the requisite six months.