WRMarketplace

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TOPIC: 409A Failure Leads to Employee Lawsuit Against Employer: Lessons Learned

MARKET TREND: A recent Sixth Circuit decision, *Wilson v. Safelite Group, Inc.* (July 10, 2019), highlights the risk to employers if the Internal Revenue Service ("IRS") finds that an employer's nonqualified deferred compensation ("NQDC") plan fails to comply with Internal Revenue Code Section 409A ("409A"). Although the court ruled in favor of the employer in this case, the court's analysis highlights important lessons for employers. The case also demonstrates that the IRS is, in fact, looking at NQDC plans' 409A compliance.

SYNOPSIS: NQDC plans that fail to comply with the requirements of 409A can be subject to significant additional taxes for the participating employees. In *Wilson*, the employee had deferred about $9 million under a NQDC plan sponsored by Safelite Group, Inc. ("Safelite"). The IRS found a 409A failure related to the deferrals during an audit and assessed 409A additional taxes of nearly $1.5 million against the employee. The employee sued Safelite under state law for breach of contract and negligent misrepresentation, claiming it was Safelite's actions that caused the assessment of the 409A additional taxes. The court determined that the NQDC plan was a "pension plan" covered by the Employee Retirement Income Security Act

of 1974 ("ERISA") and not a non-ERISA "bonus plan." Because ERISA preempts state law claims, the court affirmed the lower court's decision to dismiss the claims.

TAKEAWAYS: The facts and holding in *Wilson* highlight at least three important lessons for employers who sponsor NQDC plans:

(1) Compliance with 409A is important. The IRS is reviewing 409A compliance on audit. Failure to comply with 409A can lead to employee claims against the employer and disgruntled employees and former employees.

(2) NQDC plans should be carefully drafted as ERISA-covered plans. ERISA affords employers important protections in case of disputes, including the requirement that employees follow claims procedures and the preemption of state law claims.

(3) NQDC plans should include a carefully drafted 409A "savings clause" that waives any employee claims regarding 409A additional taxes.

Background on 409A. NQDC plans frequently provide employees with an opportunity to elect to defer payment of salary or bonuses to a later year. These plans are covered by 409A.

409A imposes strict requirements on NQDC plans, including:

- Requirements regarding the timing of deferral elections;
- A limited set of permitted payment triggers – death, disability, termination of employment, a fixed date/schedule, change in control, or unforeseeable emergency;
- A requirement that the time and form of payment be set at the time the deferral election is made; and
- Prohibitions against accelerating or further deferring payments, with very limited exceptions.

A NQDC plan must comply with these requirements both in form (i.e., the plan must be in writing and include only compliant provisions) and operation. A failure either in form or operation results in significant adverse tax results under 409A for the participating employee, including accelerated recognition of income and a 20% additional tax. Although the employer

has certain reporting and withholding obligations related to a 409A failure, the employer usually faces limited direct tax exposure for the failure.

The *Wilson* Decision. In *Wilson*, the employer, Safelite, sponsored a transaction-related bonus plan. Mr. Wilson, Safelite's President and CEO, participated in the plan. Safelite also sponsored a NQDC plan under which participants could elect to defer the payment of any bonus earned under that transaction-related plan, as well as salary and regular annual bonuses. The NQDC plan permitted participants to elect to receive deferred amounts either on an in-service date or upon termination of employment.

Between 2006 and 2013, Mr. Wilson deferred significant amounts to the NQDC plan, including an amount earned in early 2007 under the transaction-related bonus plan. By 2014, his balance under the NQDC plan exceeded $9 million. In that year, an IRS audit concluded that some of Mr. Wilson's deferral elections under the NQDC plan failed to comply with 409A. The court did not explain the details of the IRS's conclusion, but from the complaint, it appears that certain of Mr. Wilson's elections under the plan after 2008 were intended to further defer the payment of amounts that had been previously deferred. Under 409A, such further deferrals are permitted only if the election is made at least 12 months before the payment is otherwise scheduled to be made and the payment is deferred by at least another five years (what we sometimes call the "12-month/5-year" further deferral rule). Apparently, Mr. Wilson's elections did not result in the required 5-year further deferral, and therefore failed to comply with the 12-month/5-year rule. According to the complaint, the IRS assessed Mr. Wilson about $2.6 million in income taxes, almost $1.5 million in a 409A 20% additional tax, and $150,000 in interest.

Mr. Wilson sued Safelite under two state law theories. First, he contended that the NQDC plan constituted a contract under state law. Because the NQDC plan stated that it was intended to comply with 409A, but in fact did not as the result of Safelite's failures to properly design or administer the deferral elections, Mr. Wilson claimed this amounted to a breach of contract. Second, he asserted that Safelite negligently misrepresented to him that his deferral elections complied with 409A, that he reasonably relied on those representations, and that he suffered damages as a result of Safelite's negligence.

Mr. Wilson's ability to bring state law claims hinged on his argument that the NQDC plan was not a "pension plan" covered by ERISA but was a "bonus plan" outside the scope of ERISA. ERISA permits plan participants to bring claims for benefits under a plan's terms, which is a contract-like claim, but ERISA does not permit additional state law claims. This preemption of state laws is one of ERISA's key features and was intended by Congress to create a single, federal legal regime governing employee benefit plans.

A NQDC plan is an ERISA-covered "pension plan" if it either:

- provides retirement income to employees, or
- results in a deferral of income by employees for periods extending to the termination of employment or beyond.

In contrast, a plan that pays bonuses is not covered by ERISA unless payments under the plan are systematically deferred to termination of employment or beyond.

Mr. Wilson argued that because the NQDC plan permitted participants to elect in-service payments, the plan did not result in deferral of income until termination of employment. Essentially, he asserted that if a NQDC plan permits any payments before termination of employment, it could not be considered a "pension plan" under ERISA. Mr. Wilson further argued that the NQDC plan was better categorized as a "bonus plan" than a "pension plan" under ERISA because it included amounts originally earned under the transaction-related bonus plan that, in his view, were not "systematically deferred" to termination of employment or beyond.

The district court rejected these arguments, and the Sixth Circuit, on appeal, agreed with the district court. The Sixth Circuit opinion makes it clear that a NQDC plan will be considered to result in deferral of income to termination of employment or beyond if the plan generally provides for payments at or following termination of employment, even if the plan permits earlier in-service payments.

Because the court found that the NQDC plan was covered by ERISA, Mr. Wilson's state law claims were preempted and could not be made. The district court permitted Mr. Wilson to re-cast his claims as a claim for benefits under ERISA, but for reasons not explained, he chose not to do so, and the dispute ended without any liability to Safelite.

Three Key Lessons from *Wilson*. The facts and holding in Wilson highlight at least three important lessons for employers who sponsor NQDC plans:

Lesson1: Compliance with 409A is important.

The IRS indicated shortly after 409A final regulations became effective in 2009 that it would direct agents to focus on 409A compliance issues during corporate and individual audits. We have not heard much about IRS efforts since those announcements, and very few 409A-related disputes have reached the courts. *Wilson* shows us that the IRS is in fact scrutinizing elective deferral plans, so plan sponsors should be wary. *Wilson* also reminds us that the adverse tax

impact from a 409A failure can be high for NQDC participants and problematic for employers who may face adverse employee relations and employee claims.

Lesson 2: NQDC plans should be carefully drafted as ERISA-covered plans.

The decision in favor of Safelite turned on the NQDC plan being classified as an ERISA "pension plan." A NQDC plan should normally be established as a "top hat" plan – i.e., a plan intended primarily for select group of management or highly compensated employees. Although top hat plans are exempt from many ERISA provisions – they are technically ERISA "pension plans" and are subject to ERISA's dispute resolution provisions.

ERISA disputes must first be vetted through a claims procedure with the plan administrator. Courts normally review plan administrators' claims decisions under a deferential standard that reverses the decision only if it is found to have been "arbitrary and capricious." As noted in *Wilson*, ERISA also preempts state law claims, and there are no punitive damages under ERISA (although courts may award attorneys' fees).

In deciding whether a plan is covered by ERISA, the courts will consider the plan sponsor's intent as set forth in the plan document. In *Wilson*, for example, Safelite had indicated in the NQDC plan document that it was intended to be a top hat plan under ERISA. When adopting a NQDC plan, the plan sponsor should review the plan's status under ERISA with counsel and make sure the intended status is reflected in the plan document.

Lesson 3: NQDC plans should include a carefully drafted 409A "savings clause" that waives any employee claims regarding 409A additional taxes.

Wilson demonstrates that employees may make claims against their employer for the tax damages they suffer as the result of a 409A failure. Although Mr. Wilson did not succeed in his claims in this case, he might have succeeded had he pursued the matter as an ERISA claim for benefits under the plan.

There have been other cases where an employee successfully sued an employer for an adverse tax result under a NQDC plan based on a contract-like ERISA claim for benefits under the terms of the plan. For example, in *Davidson v. Henkel Corp.* (2015 BL 402308, E.D. Mich., 2015) an employee sued his employer for FICA taxes that the employee owed by reason of participation in a NQDC plan. The company assessed FICA taxes under the plan as and when monthly installment payments were made. The employee argued that the taxes should have been assessed at commencement on the lump sum value of the payments under the "special timing rule" set forth in Internal Revenue Code Section 3121(v), and that the company's failure to do so resulted in higher FICA taxes to the employee that constituted a reduction in his intended

plan benefits. The court found that, under IRS regulations, the "pay as you go" method the company used was legally permissible, but that the company was liable to the employee based on plan language specifying that FICA should have been assessed at commencement under the special timing rule.

Summary

NQDC plans should be carefully drafted considering the risk of employee claims based on tax outcomes. Many NQDC plans include a 409A "savings clause" stating that the plan is intended to comply with 409A and that the plan will be administered and interpreted consistent with that intent. As a best practice, that savings clause should also state that in no event will the employer be liable to a participant for any taxes resulting from participation in the plan, including any additional taxes that might be imposed as a result of 409A. If a participant makes an ERISA-based claim for benefits as a result of additional taxes triggered by a 409A failure, that savings clause waiver provides another argument for the employer as to why the claim should be denied.