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Agreeing to Higher Salaries Than The Company Can Afford

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Here's a scenario that may sound familiar: C-level hires of a start-up are all successful businesspeople who command six figure salaries. Soon after forming, the company puts in place employment agreements which reflect this salary history (even after taking into account equity incentives). At this stage of the game, however, the company does not have the funds to pay such high salaries and will apply the limited funds it does have toward other important expenses. "No worries," everyone thinks, "accrued but unpaid salary will be paid as soon as the company can."

Q: In the scenario described above (and minimum wage issues aside), should the company and executives enter into the employment agreements providing for salaries which cannot be paid in full as earned?

A: If the company must have the talent, the answer is "Yes," but not without some careful tax planning, as discussed further in this article.[1]

Section 409A Concerns

The major tax issue this scenario raises is Section 409A of the Internal Revenue Code relating to "Nonqualified Deferred Compensation Plans." We've dealt with Section 409A in this column before with respect to options (see Extending the Exercise Period of a Stock Option and Common Stock Valuation and Option Pricing by Private Companies). Section 409A is insidious and may be applicable to the fact pattern described above, as well.

Any "nonqualified deferred compensation" that is neither exempt from Section 409A nor compliant with its requirements will be subject to immediate income inclusion at the time a service provider has a legally binding right to the compensation (or later when the compensation vests). In addition, Section 409A imposes a 20% penalty and interest (on top of regular ordinary income tax rates). Not only is the 20% penalty problematic, but to be clear, the tax and penalty apply even if the service provider has not yet been paid!

In general, Section 409A does not apply to salary because salary is paid when earned and is not deferred. Amounts, which by their terms are to be paid within 2 ½ months of the end of the year in which a service provider vests in the amount, are "short-term deferrals" under Section 409A. "Short-term deferrals" are exempt from Section 409A.

So, to the extent payment of the regular salary in the fact pattern above is delayed but paid within the 2 ½ month short-term deferral period, there is no Section 409A issue. However, if the 2 ½ month period comes and goes and the company has not paid part (or all) of the agreed-to salary, Section 409A becomes relevant.

The final Treasury regulations try to soften the harsh results of Section 409A and permit salary to be delayed beyond the 2 ½ month period without income inclusion and penalty where "payment by the end of the applicable 2 ½ month period would have jeopardized the ability of the service recipient to continue as a going concern, and provided further that the payment is made as soon as administratively practicable or as soon as the payment would no longer have such effect."

Jeopardize the Ability of the Company to Continue as a Going Concern

If the "going concern" exception applies, then the service provider need not worry so long as the compensation is paid as soon as the company existence as a "going concern" is no longer in danger. Unfortunately, the scope of what it means to "jeopardize the ability… to continue as a going concern" is unclear. Initial proposed Treasury regulations provided that a payment could be delayed without violating Section 409A in order "to avoid a violation of a loan covenant or similar contractual obligation, where such violation would cause material harm to the service recipient." The "going concern" standard found in the final Treasury regulations is meant to liberalize the rule found in the proposed Treasury regulations. Thus, insolvency and a violation of a loan covenant or similar contractual obligation likely would satisfy the "going concern" rule as would other situations where the facts and circumstances warrant it. However, it is unclear whether concerns about cash flow management (recall, in the fact pattern above, the company is paying other amounts due) alone satisfy the "going concern" standard.

Advance Planning

Given the uncertainty of the "going concern" exception, creativity and advance tax planning are warranted. The company and the executive can address the issue by providing in the employment agreement for a lower realistic amount of salary, so no portion of a "too high" salary must be deferred. The remainder of the compensation necessary to attract the executive can be structured to be either Section 409A-exempt or Section 409A-compliant, both of which will avoid the Section 409A immediate income inclusion and penalty.

Section 409A-exempt alternatives: It will not violate Section 409A, if the company and the executive provide in the employment agreement that, so long as the executive is providing services upon (or within a short period of time before) a triggering event that will provide sufficient liquidity (e.g., a financing meeting a certain level of investment), the executive will get a bonus equal to the salary he would have been paid were his salary higher from the date of hire. It will also not violate Section 409A if the parties agree in the employment agreement that upon a certain event, the executive's salary will be bumped up (permanently or for a period of time) to make him or her whole for the amounts forgone. However, the parties need to consider whether investors will want their newly invested monies to pay for past salaries. Setting a triggering event that will not result in sufficient liquidity and promising executives tens of thousands of dollars upon such event does not make sense and will likely result in the deferral the parties were trying to avoid.

Section 409A-compliant alternatives: It will also not violate Section 409A, if the company and the executive agree in advance in writing to "accrue" (i.e., "defer") the amounts required to make the executive whole and pay the executive those amounts upon a Section 409A-permitted event, including, death, disability, change in control, separation from service or unforeseen emergency. Such an arrangement would address Section 409A which requires that, at the time the executive and Company enter into an employment agreement providing for deferred compensation there is a written plan document, an election to defer is made, and a pre-designated Section 409A-permitted payment event is set. (Note: except for in the case of a "make-whole" payment to be made upon a change in control, the parties still run the risk that there is insufficient liquidity at time of the permitted event to make the agreed payment.)

Post-Agreement Planning

What if the company and the executive already find themselves in a situation that may violate Section 409A? The objective here is to limit exposure. With respect to past unpaid salary under the employment agreement, if the "going concern" exception applies, the Company must pay the unpaid salary out as soon as the Company existence as a "going concern" is no longer jeopardized by making the payment. (As described above, however, relying on the "going concern" exception involves risk.) With respect to future unpaid salary for the current year in which the discovery of the potential Section 409A issue was made, reduce salary to the level that can be paid. The Company and the executive might be tempted here to reduce the current year salary and provide that an amount equal to the reduction is paid at a later time. This will not fix the Section

409A issue because of the election rules described above and Section 409A's strict rules on "substitutions" of current salary for future salary.

With respect to salary for future years, the Company and executive may agree that the Board may increase salary as conditions warrant it. Likely, the executive will want more comfort than that. The Company and executive may agree to a Section 409A compliant alternative (described above).

Section 409A is a complex set of rules governing "nonqualified deferred compensation." This discussion only scratches the surface. Consult your tax advisor if Section 409A might apply to you.

For more information, please contact **Chip Wry**.

Footnotes.

1. Note that this article addresses the potential tax issues associated with this scenario. This scenario also raises employment Wage Act issues which must also be considered.