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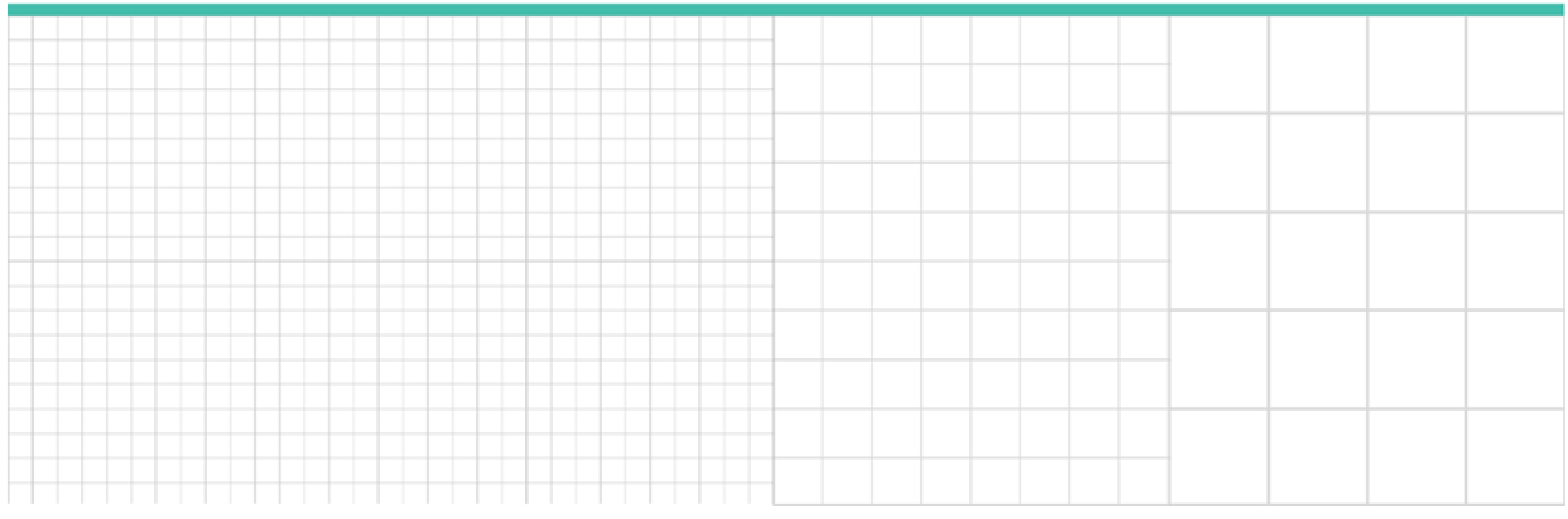
Executive & Director Compensation Reference Guide

409A Litigation



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409A Litigation

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In response to the Enron scandal, the IRS introduced § 409A into the tax code in 2005. While the tax code has long recognized an employee's ability to defer compensation until a later date, usually when the employee enters retirement and is in a lower tax bracket, § 409A sought to prevent executives from accelerating payments from their deferred compensation plans without reaping any tax consequences. Section 409A sets forth stringent requirements for non-qualified deferred compensation arrangements, which generally don't permit acceleration or postponement of deferred compensation except under limited circumstances.

If it is determined that a non-qualified deferred compensation plan doesn't satisfy the § 409A requirements, the employee-recipient will face extensive taxes and penalties. The largest consequence is that the employee's taxable income will be adjusted to include the entire balance of the deferred compensation plan, going back to the year the options were vested. In addition, there is a 20% excise tax on that new amount, as well as a one percent tax on underpayments beginning at the year in which compensation was first deferred. As expected, these additional taxes are much greater than what would be owed if all of the § 409A requirements were met.[1]

[1] Use SmartCode® to view the latest cases on § 409A income inclusion requirements for deferred compensation.

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Employers are often the ones responsible for drafting and maintaining deferred compensation plans. Executive employees usually rely on their companies to ensure that the plans comply with § 409A. Recently, an issue arose regarding whether an employer could be held liable for negligently maintaining a non-qualified deferred compensation plan.

In July 2019, the Sixth Circuit held that an executive couldn't recover from his employer after the employer mismanaged a deferred compensation plan.[2] In *Safelite*, the company offered a non-qualified deferred compensation plan to its executive employees. Wilson, who was the President and CEO of Safelite from 2003 to 2008, submitted an election form under this compensation plan and elected to defer more than $9.1 million in compensation throughout his employment. In 2014, an audit of Safelite revealed that many of Wilson's deferred compensation elections didn't comply with § 409A. As a result, Wilson owed additional income taxes, plus extensive penalties. Wilson then filed suit for breach of contract and negligent misrepresentation, alleging that Safelite mismanaged its deferred compensation plan. Safelite moved for summary judgment, arguing that Wilson's state law claims were preempted by ERISA. The district court granted Safelite's motion and gave Wilson 28 days to amend his complaint to assert claims under ERISA's civil enforcement provision. Wilson decided not to amend his complaint and, instead, appealed to the Sixth Circuit.

[2] *Wilson v. Safelite Group, Inc.*, 930 F.3d 429 (6th Cir. 2019).

The Sixth Circuit ultimately affirmed the district court's grant of summary judgment. The Sixth Circuit agreed that Safelite's deferred compensation plan qualified as an "employee pension benefit plan" under ERISA because the plan "results in a deferral of income by employees for periods extending to the termination of covered employment or beyond."[3] Wilson also argued that the Safelite plan fell under the bonus plan exemption for ERISA coverage. The Sixth Circuit disagreed and held that the Safelite plan did not constitute a bonus plan, as it "does not state an intention to provide financial incentives for employee performance or retention and does not explicitly operate as a bonus plan."[4] Because the Safelite plan qualified as an ERISA plan, Wilson's state law breach of contract and negligent misrepresentation claims were preempted.[5]

[3] *Safelite*, 930 F.3d 429, 433 (6th Cir. 2019). See the Point of Law on this issue.

[4] *Safelite*, 930 F.3d 429, 438 (6th Cir. 2019).

[5] *Safelite*, 930 F.3d 429, 434 (6th Cir. 2019). See the Point of Law on this issue.

Safelite is the first and only case to rule on this issue. No other court has interpreted whether an executive can sue an employer for the amount lost due to improper withholding under § 409A. Two courts have, however, ruled on similar questions relating to an employer's liability for other types of negligent misrepresentations in retirement or compensation plans. Notably, in one of these cases the plaintiffs sued under ERISA's civil enforcement provision, which is the claim that Wilson failed to assert in *Safelite*.

For example, in *Davidson v. Henkel Corp.*,[6] the Eastern District of Michigan held that a corporation could be held liable under ERISA for failing to properly withhold and pay FICA taxes under a deferred compensation and retirement plan. Under Henkel's deferred compensation and supplemental retirement and investment plan, employees would defer their compensation until the time of their retirement, at which time employees would presumably be taxed in a lower tax bracket. After several employees retired and began receiving their monthly supplemental benefit under the plan, Henkel discovered that Social Security FICA taxes hadn't been withheld or paid at the time they were initially due under the tax code. Because of Henkel's failure to properly withhold, employees were subject to extensive FICA taxes on their retirement payments going forward. The employees then filed a class action bringing claims for civil enforcement and equitable estoppel under ERISA § 502(a).

[6] No. 12-CV-14103, 2015 BL 1384 (E.D. Mich. Jan. 6, 2015).

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After extensive discovery, both plaintiffs and Henkel filed motions for summary judgment. The court made several rulings when deciding these motions. First, the court rejected Henkel's argument that it wasn't liable because it "resolved the FICA tax issue exactly as it was supposed to do under the applicable regulations." [7] The court reasoned that the issue in the case was not whether Henkel correctly handled the taxes after FICA issues arose, but rather Henkel's role in *how* the FICA issue arose. Second, the court held the tax code didn't preempt the plaintiffs' claims, reasoning that "the mere fact that the plaintiffs' damages are calculated in terms of taxes does not necessitate the conclusion that the plaintiffs' claim[s] must actually be . . . for a federal income tax refund." [8] For these reasons, the court denied defendants summary judgment motion. Finally, the court analyzed whether plaintiffs were entitled to summary judgment and specifically whether there was any disputed fact that Henkel committed a FICA error in violation of the retirement and investment plan. [9] In reaching its decision, the court noted that "[a] primary purpose of ERISA is to ensure the integrity and primacy of the written plans." [10] Although Henkel didn't violate federal tax law, because Henkel was permitted to withhold plaintiffs' taxes in the way that it did, Henkel still "violated provisions of the Plan and the Plan's purpose." [11] The plan vested Henkel with control over the plaintiffs' funds and required Henkel to "properly handle tax withholding from those funds." [12] Ultimately, the court granted plaintiffs' motion for summary judgment on the ERISA civil enforcement claim.

[7] *Henkel,* 2015 BL 1384, at *3 (E.D. Mich. Jan. 6, 2015).

[8] *Henkel*, 2015 BL 1384, at *5 (E.D. Mich. Jan. 6, 2015). See the Point of Law on this issue.

[9] *Henkel,* 2015 BL 1384, at *6 (E.D. Mich. Jan. 6, 2015).

[10] *Henkel,* 2015 BL 1384, at *7 (E.D. Mich. Jan. 6, 2015). See the Point of Law on this issue.

[11] *Henkel,* 2015 BL 1384, at *8 (E.D. Mich. Jan. 6, 2015).

[12] *Henkel,* 2015 BL 1384, at *9 (E.D. Mich. Jan. 6, 2015).

Similarly, a Wisconsin court relied on *Henkel* in holding that federal tax law didn't preempt teachers and administrators' claims against a school district for negligent representations relating to a § 403(b) retirement plan. [13] In *Cattau*, dozens of teachers and administrators filed suit against the District, alleging that the District "negligently represented that if they agreed to retire, they would receive ten years of payments under a 403(b) plan administered by the District." [14] Under federal tax law, however, a § 403(b) retirement plan only permits payments to be made over five and one-half years. Due to the District's negligent representation, the teachers and administrators had to pay additional income taxes and interests for the four and one-half years of payments that didn't fall under § 403(b). The trial court dismissed the plaintiffs' claims, reasoning that they were preempted by federal tax law because plaintiffs cannot attempt to "'circumvent' federal tax law and use a state court forum to receive improper tax advantages for ten years of post-employment compensation." [15] The court of appeals reversed, citing *Henkel*, and clarifying that the "plaintiffs' allegations are not about taxes wrongfully withheld under applicable tax law, but about whether the plaintiffs' damages, including taxes and interest that would not otherwise be paid under applicable tax law, were caused by defendants' representations and administration of the plan." [16] Notably, the court of appeals held only that federal tax law didn't preempt plaintiffs' claims. The court didn't rule substantively on whether plaintiffs' claims would survive a motion to dismiss for failure to state a claim.

[13] *Cattau v. Nat'l Ins. Servs. of Wisconsin, Inc.*, 865 N.W.2d 215 (Apr. 29, 2015).

[14] *Cattau,* 362 Wis. 2d 524, 856 N.W.2d 215, at 217.

[15] *Cattau,* 362 Wis. 2d 524, 856 N.W.2d 215, at 219.

[16] *Cattau,* 362 Wis. 2d 524, 856 N.W.2d 215, at 222.

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