EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION
INFORMATION MEMO
MAY 31, 2024

Recent Developments in the World of Sports Provide an Opportunity for a Refresher on Internal Revenue Code Sections 409A and 457(f)

While the news cycle in the world of sports is ever changing, a few occurrences in the past several years deserve further discussion in the executive compensation community – Shohei Ohtani's deferral of $680 million in salary from the Los Angeles Dodgers and the high profile buy-outs of several college football coaches' contracts. Although most executives and employers will never be involved in situations with these dollar figures, the issues under Sections 409A and 457(f) of the Internal Revenue Code ("Code") implicated by these scenarios are also implicated in many common executive compensation arrangements. The arrangements provide an interesting window for employers and executives to refresh their knowledge of common issues that can arise in their own executive compensation arrangements.

Before delving into the Code analysis in more detail, it is important to note that this author has no knowledge of the actual arrangements involving Mr. Ohtani or any of the college football coaches whose contracts have recently been bought out and is relying on what has been publicly reported. Furthermore, this author is not speaking to any Major League Baseball or NCAA issues implicated by these arrangements and is limiting this discussion solely to Code Section 409A and 457(f) issues.

We will start with an analysis of Mr. Ohtani's contractual arrangement with the Los Angeles Dodgers which is at its inception, then examine an illustrative payout made to a college football coach following the termination of employment.

<u>Mr. Ohtani's Deferred Payments</u>

In 2023, Mr. Ohtani signed a 10-year, $700 million contract to play for the Los Angeles Dodgers of Major League Baseball. Aside from the staggering amount of the contract, what caught the eye of this author is that Mr. Ohtani will only receive $2 million per year during the 10-year period that he has agreed to play for the Dodgers and will defer $68 million per year. The $680 million of deferred compensation will then be payable to Mr. Ohtani between 2034 and 2043 without interest. Before entering into this arrangement, the Dodgers and Mr. Ohtani must have understood the Code Section 409A issues implicated. The Dodgers are a for-profit entity (i.e., not a tax-exempt entity), and therefore Code Section 457(f) is inapplicable.

Unless an exception applies, Code Section 409A applies to "non-qualified deferred compensation plans." Such phrase is defined to mean any arrangement under which a legally binding right to compensation arises in one taxable year and payment is deferred to a later taxable year. Violations of Code Section 409A can result in premature income recognition, the imposition of substantial interest penalties and the imposition of a 20% excise tax on covered individuals. Therefore, the first question to examine with Mr. Ohtani's arrangement is whether it is excepted from Code Section

409A.

The two most common exceptions to Code Section 409A are: (1) the short-term deferral exception; and (2) the separation pay plan exception. The separation pay plan exception applies to payments made in connection with a termination of employment (e.g., severance payments), and therefore is not applicable to Mr. Ohtani's arrangement. In contrast, the short-term deferral exception can apply to a broader range of scenarios.

Generally, an arrangement under which the entire promised amount is paid within 2½ months after the end of the first taxable year in which the amount is no longer subject to a "substantial risk of forfeiture" falls within the short-term deferral exception. The regulations implementing Code Section 409A state that compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation and the possibility of forfeiture is substantial. In other words, compensation is subject to a substantial risk forfeiture if the recipient of the compensation must continue in employment for a certain period of time to receive the payment, or otherwise forfeit the payment.

Mr. Ohtani's $680 million in deferred compensation is to be paid over a 10-year period following the expiration of his current contract with the Dodgers. Therefore, his deferred compensation is not conditioned on his performance of substantial future services, is not subject to a substantial risk of forfeiture and does not fall within the short-term deferral exception. Even if Mr. Ohtani's right to the deferred compensation was subject to a substantial risk of forfeiture, the entire amount would need to be paid within 2½ months after the end of the first taxable year in which the amount became no longer subject to the substantial risk of forfeiture, which Mr. Ohtani's contract is not structured to do.

As a result of the above analysis, Mr. Ohtani's arrangement is subject to Code Section 409A. If Code Section 409A is complied with, Mr. Ohtani's deferred compensation is not includible in his income until the tax years in which the amounts are actually paid (however, there is an important exception to this statement for FICA taxes which is outside of the scope of this discussion). If Code Section 409A is not complied with, then amounts would be includible in Mr. Ohtani's income on the vesting date even if not yet payable and the additional adverse tax consequences described above (including the imposition of a 20% excise tax) would also be implicated. While the majority of the adverse tax consequences of failing to comply with Code Section 409A would fall on Mr. Ohtani, the Dodgers are required to correctly report and withhold on such amounts and would be subject to liability for failure to do so.

After determining that deferred compensation is subject to Code Section 409A (i.e., the deferred compensation does not fall within one of the above exceptions, or one of the other exceptions set forth in the regulations under Code Section 409A, none of which are applicable here), the next exercise is understanding how to comply with the requirements of Code Section 409A. As an initial matter, an election to defer future compensation must be irrevocable. In other words, once Mr. Ohtani decided to structure his contract so that $680 million would be paid as deferred compensation, he cannot subsequently decide to reverse course except in certain limited circumstances. Furthermore, Mr. Ohtani's contract must set forth the events, dates and forms of distribution of his deferred compensation. Code Section 409A generally only permits the distribution

of deferred compensation upon the occurrence of specified events, which are limited to: (1) separation from service; (2) disability; (3) death; (4) a specified fixed date; (5) a change in control; or (6) an unforeseeable emergency. Once payment dates are fixed, payment cannot be accelerated or modified except in certain limited circumstances.

While Mr. Ohtani may want the Dodgers to set aside the $680 million solely for the purpose of paying his deferred compensation (and not for any other payments), this cannot happen. To receive the tax treatment described above in which no amounts are includible in income until actually paid, the non-qualified deferred compensation arrangement cannot be considered “funded” (in contrast to the tax treatment of qualified deferred compensation arrangements, such as 401(k) plan contributions). If an employer irrevocably sets cash or other assets aside for the exclusive benefit of an employee, it transfers to the employee a beneficial interest in those assets that is beyond the reach of the employer’s creditors. In this instance, the employer has “funded” the promise to pay the non-qualified deferred compensation, and, under the economic benefit doctrine, income would be includible prior to actual payment.

While the Dodgers cannot “fund” their deferred compensation obligation to Mr. Ohtani, other steps could be taken to give Mr. Ohtani some sense of security that his payments will be made. For example, using a “Rabbi Trust” or corporate-owned life insurance.

Severance Payments

While the above is exemplary of several issues that should be considered when entering into an employment relationship that provides for non-qualified deferred compensation, examining the payments that are commonly made to college football coaches following their termination of employment prior to the expiration of their contract can provide insight into executive compensation considerations implicated when the employment relationship is terminated.

Consider the following common scenario: Coach signs an agreement to be employed by College as head football coach in 2020, paying Coach $7.5 million a year until 2030. Coach’s agreement also includes a clause that if Coach is terminated without cause prior to the expiration of the contract, Coach is entitled to a payment of $20 million to be made within 60 days of termination. Coach is terminated by College without cause in November 2024, earlier than the expiration of Coach’s contract, triggering the $20 million buyout within 60 days of termination. In addition to the Code Section 409A issues described above, this Coach and College must also consider Code Section 457(f) because Coach was employed by a College, which is a tax-exempt entity. While perhaps not for $20 million, it is not uncommon for executives of tax-exempt entities to receive some form of severance if the executive is terminated without cause (or resigns for “good reason”) during the term of the executive’s employment agreement.

To begin, Coach’s buyout constitutes non-qualified deferred compensation because Coach had a legally binding right to the compensation in one taxable year and payment was deferred to a later taxable year. As such, Coach’s buyout is subject to both Code Sections 409A (summarized above) and 457(f). Payments provided under an arrangement subject to Code Section 457(f) are taxed upon the earlier of (i) the date a legally binding right to the benefit arises, or (ii) the date the benefits are no longer subject to a substantial risk of forfeiture. In contrast to Code Section 409A, payments subject to Code Section 457(f) are includible in income pursuant to the preceding sentence even if

payment is not made until a later date.

Similar short-term deferral and separation pay exceptions apply under both Code Section 409A and 457(f) (with several important differences). Therefore, the accelerated income tax treatment described in the preceding paragraph will not apply if Coach's buyout can fall within one of the enumerated exceptions.

The separation pay plan exception requires that payments be made solely on account of an involuntary termination of employment (or a good reason resignation by the employee if certain requirements are met), the payments cannot exceed two times the employee's annualized compensation (Code Section 409A provides an additional requirement that the payments cannot exceed twice the Code Section 401(a)(17) limit), and payments must be made no later than the end of the second year following the year of termination of employment.

Coach's $20 million buyout does not meet the separation pay exception because it is more than twice his annualized earnings ($15 million).

However, Coach's buyout is paid within 60 days of his termination date and therefore can meet the short-term deferral exception because it is paid within 2½ months after the end of the taxable year in which the compensation is no longer subject to a substantial risk of forfeiture.

It is important for arrangements similar to the above entered into by tax-exempt entities with executives to satisfy an exception to Code Section 457(f) because any payments that do not meet an exception will be subject to Code Section 457(f), and will be included in the executive's income on the date the payment is no longer subject to a substantial risk of forfeiture, even though payment may not have actually been made.

If you have any questions about this information memo please contact Daniel J. Nugent, any attorney in our employee benefits and executive compensation practice group, or the attorney at the firm with whom you are regularly in contact.

Bond has prepared this communication to present only general information. This is not intended as legal advice, nor should you consider it as such. You should not act, or decline to act, based upon the contents. While we try to make sure that the information is complete and accurate, laws can change quickly. You should always formally engage a lawyer of your choosing before taking actions which have legal consequences. For information about our firm, practice areas and attorneys, visit our website, www.bsk.com. Attorney Advertising. © 2024 Bond, Schoeneck & King PLLC.