

CORPORATE COUNSEL

Hurdle for the Unwary: How To Pay Independent Contractors

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Uncertain times challenge entrepreneurs and their contractors to develop compensation packages that mix expectation and current return. The tax law governing deferred compensation pushes parties toward current income, but economic exigencies pose dilemmas for business owners who seek to keep control while promising future riches.

How entrepreneurs structure the payments may turn on the impact of Internal Revenue Code Section 409A.

Take the example of an entrepreneur who wants to bring on a software developer to write code for the new business. The entrepreneur wants to motivate the developer to produce quality software on time and on budget but does not want to be saddled with the developer as a junior partner in the long run.

Moreover, the entrepreneur often lacks cash and wishes to take any deduction when there is more revenue.

If the software makes the business successful, the developer should receive compensation commensurate with that success. But the developer does not want

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to work for nothing if the venture fails.

The health of the stock market often shapes the compensation package. When the market soars, contractors often accept common stock as compensation. It's inexpensive for the entrepreneur and can be lucrative for the contractor.

However, stock market crashes have shown that taking stock as compensation can be risky. As is the case now, when the IPO pipeline is clogged, unsecured promises to pay cash in the future may seem more attractive.

Since 2004, deferred compensation arrangements have carried the potential for unusually adverse tax consequences under Section 409A. Adopted by Congress in response to accelerated receipt of "deferred" income by Enron executives, the section taxes compensation when it is earned, rather than when it is paid.

At the same time, Congress imposed substantial taxes on some deferred amounts. When it applies, Section 409A makes the service provider recognize as current income the entire deferred amount, together with an additional 20 percent of the deferred compensation. Higher-than-normal interest rates may apply as well. Therefore, every service provider wants to avoid 409A.

In structuring contractor payments, entrepreneurs will want to address sev-

eral questions:

- Is the payment compensation? Section 409A deals with "non-qualified deferred compensation plans." A schedule of payments to one person may constitute a "plan" but the payments may not constitute "compensation."

For example, if the startup pays for hours worked, the arrangement could be compensation for services. But if the startup purchases software, for example, the payments may not constitute compensation.

These choices have effects. If the parties make a "work for hire" agreement for services, the entrepreneur may be able to deduct the current payment immediately. But if the startup purchases software, the parties may have to capitalize the cost and write it off over time. And, if the payments constitute license payments, the software ownership may not end up where the entrepreneur plans.

- Is the service provider independent enough to avoid Section 409A? To do so, an independent contractor must provide "significant" services to two or more unrelated service recipients while actively engaged in the relevant trade or business. In addition, the contractor must receive less than 70 percent of total revenue from one service recipient, ordinarily measured when the independent contractor obtains a legally binding right to the compensation.

Although legitimately actively engaged in the relevant trade or business, sometimes a contractor may engage in a large project that prevents his meeting the 70 percent standard. Luckily,

the regulations provide an additional safe harbor for a contractor that meets the test for the three years immediately preceding the year in question.

• Is payment deferred? Section 409A deems payment deferred if the service recipient does not pay the compensation in the year the contractor obtains a legal right to it. A written agreement that establishes a right to compensation subject to conditions, such as the passage of time, creates a deferral. If payment is subject to a substantial risk of forfeiture, Section 409A measures deferral from lapse of the substantial risk of forfeiture, rather than from the contract date.

However, to avoid Section 409A, the agreement should require payment by the 15th day of the third month after the tax year of the service provider or the service recipient (whichever is later) in which the substantial risk of forfeiture ends.

Timing matters. As protection from Section 409A, the service provider will want to elect deferral during the year immediately preceding the year in which the service provider performs.

Often, the parties elect deferral because sometimes when the contractor does the work, the startup lacks the cash to pay and the information to ascertain the genuine economic value of new software. On the other hand, Section 409A increases

the service provider's exposure.

• Does payment become due when the statutory scheme permits? Congress did not intend to stop all subsequent-year payments, but wanted to reduce executive self-help.

Therefore, Congress permitted deferred payments in these situations not controlled by the service provider: nondiscretionary payments may occur at a specific date or on an objectively determinable fixed schedule; payments may occur on the service provider's death, disability or separation from service; payments may be received at the point of a change of control of the service recipient or its corporate parent or of the service recipient's assets; and payments may occur after an "unforeseeable emergency."

• Did the entrepreneur and contractor make an adequate record of the arrangement soon enough? A nonqualified deferred compensation plan exists when the payee has a legal right to receive future compensation.

Every contractor will want to set forth in writing the calculation of the amount deferred, a statement of any substantial risk of forfeiture and the time and form of the payment. Savings clauses may prove ineffective.

• Is the compensation payable in stock? Section 409A may apply to grants

of stock, stock options or stock appreciation rights (SARs). Section 409A's impact particularly affects rights granted with an exercise price below market values at the date of grant.

Section 409A does not apply to payments under normal sorts of qualified retirement plans.

To provide stock or SARs as the contractor's compensation, the issuer must make a good-faith effort to comply with the Treasury Department regulations on share valuations. The compensation may be payable in stock at the time of a change in control, but, to avoid Section 409A, the compensation needs to be fixed in advance and calculable based on factors outside the control of the parties.

The service provider particularly bears Section 409A's costs. However, the service recipient is required to report deferred payments on a contractor's Form 1099. Therefore, both parties have an interest in correct treatment under Section 409A.

Section 409A takes up less than half a dozen pages of the Internal Revenue Code but scores of pages of regulations. Because the regulations have been evolving, few cases have moved through the system. As more practitioners understand this code section, its impact will become clear. ■