A compensation package deferred

Section 409A of the Internal Revenue Code continues to drive the creation, implementation – and correction – of nonqualified deferred compensation plans.

Gone are the days of discretionary payouts, random decisions to further defer a given payment or a decision to simply end a deferred comp arrangement and call it a day. Enacted in 2004, Section 409A regulates the form and content of many types of nonqualified deferred compensation arrangements.

The cost for noncompliance with Section 409A is high – 20 percent additional income tax on a faulty deferred compensation payment, plus possible interest and penalties. Further, it is the employee (the "service provider" in 409A parlance) who is liable for this penalty, not the employer (the "service recipient").

A plan provides for deferred compensation if the employee has a legally binding right in one tax year to payment in a later tax year. Given this broad description, nonqualified deferred compensation plans subject to 409A can include any of a variety of arrangements, including salary deferral arrangements, severance agreements, nonqualified stock option agreements or plans providing stock appreciation rights.

It is easier to list what parties to a plan or arrangement must avoid, rather than what a plan must contain, to comply with Section 409A when drafting or administering nonqualified deferred comp arrangements. Don’t:

• Make distributions earlier than those events specified in 409A, such as separation from service, disability or death

• Accelerate the time or schedule of payments under the plan

• Permit elections to defer initial payments unless elections are made in the year prior to the payment year

• Permit subsequent deferrals unless they comply with the timing rules of 409A

• Terminate an existing plan unless the termination complies with the permitted processes described in 409A guidance.

Correction provisions

After final 409A regulations were issued in 2007, the IRS issued various notices that describe acceptable methods of correction for noncompliant deferred compensation plans. In particular, Notice 2010-6 describes acceptable corrections for errors in the written form of a plan.

Depending on the type of correction utilized, an employer may also need to attach a statement to its income tax

return, telling the IRS that it did, in fact, make a correction under the Notice; employees may need to pay a penalty as part of certain corrections.

Notable among the correction provisions is the treatment of a release of claims that an employer may require before a payment will be made to an employee under a deferred compensation agreement.

As a starting point, an agreement may still contain release language and remain compliant with 409A. However, the IRS requires that a proper release in a compliant deferred comp arrangement must expressly prevent the tinkering by employee or employer with the tax year of payment.

For example, if Employee X terminated employment on Nov. 1, 2010, and X's severance agreement provides a stream of payments that begins on account of that severance - but only after signing a release - the employee could cause the payments to start in 2010 by executing a release before the end of the year.

Alternatively, X could delay the start of payments by waiting until Jan. 1, 2011, to sign the release. This is anathema to the IRS.

As one remedy, the IRS states that imposing a date certain for the start of payments – for example, 60 days after termination, provided a release is executed by then - will prevent toying with the tax year for payments. A release can still be required, but payment will be made or begun on that specified date post-termination, regardless of whether the release is actually signed on day 6 or day 60.

Notice also that 2010-6 permits correction of existing noncompliant release language, subject to certain deadlines depending on whether payments have already been made under faulty language.

Unfortunately, employees, employers and practitioners are at the mercy of the IRS' ongoing musings about 409A.

In fact, a subsequent Notice 2010-80 already modifies some of the guidance in Notice 2010-6. What appeared to be a compliant arrangement last year may now be at risk of noncompliance due to modifications in IRS guidance. Perhaps 409A was written into the tax code as a sort of Trojan horse – to confound continued use of nonqualified deferred compensation arrangements, since they can be so easily mishandled, resulting in potentially serious financial consequences.

It is worth the time and cost to carefully review anticipated terms when crafting a deferred compensation arrangement. While it is possible to make corrections after an arrangement is in place, the cure can carry its own pain in the form of confessional tax filings and additional tax payments. And remember: It is the employee who is the "taxpayer" at risk in this section of the Tax Code.

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