Ask the Expert

Q.

What is deferred compensation and what issues should I be looking out for when making or reviewing these arrangements with my employees?

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Deferred compensation includes non-qualified stock options, stock appreciation rights plans, bonuses that are paid in a separate calendar year, or extended severance arrangements. For many years, employers exercised enormous flexibility (and creativity) in forming deferred compensation arrangements. However, with the addition of Section 409A to the Internal Revenue Code of 1986, as amended (the "Code"), as added by the American Jobs Creation Act of 2004, the rules of the game changed dramatically. Although the law may not be "new" news, the IRS has recently indicated in an employment auditing initiative that it may be focusing on deferred compensation arrangements and compliance with Section 409A.

For Section 409A purposes, the term "deferred compensation" is explained as compensation to which a service provider (an employee, for example) has a legally binding right during a taxable year, which has not been previously taxed, and that is payable in a later taxable year. Basically, money earned in one year but payable and taxable in a later year (with some limited exceptions) is deferred compensation. Section 409A contains rules regarding payouts, funding methods and the timing of deferral elections. Some examples of arrangements subject to 409A are elective and non-elective salary deferrals, bonus or fee deferrals, supplemental retirement plans, certain equity-based compensation arrangements (e.g., stock options/SARs, unless specifically exempted) and some severance arrangements. Section 409A excludes certain benefits under so-called "Qualified Plans" (e.g., 401(k) plans) which are highly regulated, and there are some other rather narrow exceptions such as welfare benefit plans. Therefore, the initial question for employers and recipient employees is whether a proposed or existing compensation arrangement falls within the purview of 409A and, if so, whether it complies with those rules and regulations.

Non-compliance with these rather technical rules can lead to severe penalties. Specifically, all non-compliant amounts of deferred compensation become immediately taxable and required to be included in the employee's gross income along with an additional penalty of an amount equal to 20% of the compensation! Note that it is the employee, often an executive, who owes the tax. However, for obvious reasons, employers have a strong interest in getting this right.

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