

Code Section 409A Q&A

1. What Is Section 409A of the Internal Revenue Code?

Section 409A of the Internal Revenue Code (the “Code”) regulates nonqualified deferred compensation arrangements (i.e., compensation that employees earn in one year, but that is paid in a future year) and imposes severe tax penalties if violations occur.

Section 409A is broad in its reach, and covers nonqualified deferred compensation plans, severance plans, employment agreements and any other plans that result in deferral of compensation.

2. What Does Section 409A Require?

1. Provides detailed rules for the timing of deferral elections;
2. Prohibits acceleration of payments of deferred compensation;
3. Permits payments only upon the occurrence of certain events; and
4. Substantially limits the ability to further defer payments.

Section 409A and the guidance issued by the Internal Revenue Service (“IRS”) are so restrictive that current plans will need to be reviewed to assess whether or not a plan complies with Section 409A or meets a narrow grandfather provision or an exception. Section 409A is applicable to amounts deferred in taxable years beginning after December 31, 2004.

3. Why Should Employers Care About Section 409A?

Employers need to be concerned about violations of Section 409A because the penalties for Section 409A violations are significant, and are imposed directly on the executive/employee who receives the deferred compensation. Penalties include:

1. Immediate inclusion in taxable income (i.e., ordinary income tax) of the amount of compensation deferred for each year in which the amount was deferred regardless of whether the compensation has been paid; PLUS
2. An additional 20% income tax on the amount deferred; PLUS
3. Additional interest and penalties for failure to timely remit the income taxes. This includes interest at the IRS underpayment rate plus 1%.

While employers are not directly subject to penalties for Section 409A violations, they may decide or have agreed to pay any 409A tax penalties incurred by their employees. In addition, employers may face associated tax reporting and withholding penalties.

The IRS has not issued guidance as to how the penalties will be applied, but some possible illustrations include the following:

A. Penalty Illustration 1 (One Year Violation)

- Executive has a \$300,000 benefit payable under a plan subject to 409A.
- Plan is not exempt from 409A and does not comply with 409A.
- Executive has a total tax liability of \$165,000 in year of noncompliance.
 - This includes income tax at a 35% rate in the amount of \$105,000.
 - This includes an additional 20% penalty in the amount of \$60,000.
- Noncompliance has caused the benefit to be reduced to \$135,000.
 - **The tax liability (\$165,000) is greater than the benefit (\$135,000).**
- Interest would also accrue if tax and penalty are not paid in the year in which they are due.

B. Penalty Illustration 2 (Multiple Year Violation)

- A deferred compensation arrangement was established in January 2006, in which \$100,000 is deferred each year.
- A Section 409A violation occurs in September of 2008.
- Interest and penalties are assessed from January 2006 when the arrangement was first effective for a total tax liability of \$165,000.
 - This includes income tax at a 35% rate in the amount of \$35,000 for each year of noncompliance (2006, 2007, and 2008) for a total of \$105,000.
 - This includes an additional 20% penalty in the amount of \$20,000 for each year of noncompliance for a total of \$60,000.
- Noncompliance has caused the benefit to be reduced from \$100,000 to \$45,000 per year (or from \$300,000 to \$135,000 in total benefit).
 - **The tax liability (\$165,000) is greater than the benefit (\$135,000).**
- Interest would also accrue if tax and penalty are not paid in the year in which they are due (tax years 2006 and 2007).

4. Are There Any Adverse Consequences If An Employee Participates in Multiple Deferred Compensation Plans?

Yes. Section 409A contains plan aggregation rules. Thus, all amounts deferred with respect to an employee under all plans of an employer that fall within a particular category are treated as deferred under a single plan. The plan aggregation rules are important if one or more plans within a category of plans does not satisfy the requirements of 409A.

The penalties discussed in item 3, above, apply not only to the offending plan or arrangement, but also to all similar or like plans or arrangements of the same employer, even if those similar or like plans comply with Section 409A. The implication of this plan aggregation concept means that a Section 409A violation with respect to one plan (e.g., a stock option) could negatively affect all other arrangements of that same type.

5. Why Should Employers Focus on Section 409A Now?

The deadline to comply with Section 409A is December 31, 2008. Compliance with require the review of ALL non-exempt deferred compensation plans.

6. Should We Be Concerned That the IRS Will Audit our Clients Plans for Section 409A Compliance?

Yes. As part of its executive compensation initiative implemented for all audits, the IRS is already training its agents in the intricacies of Section 409A. In fact, there have been reports that some plans have already been audited for good faith compliance with 409A. IRS audits will include a review of plans and arrangements for compliance with Section 409A beginning with the 2005 tax year.

7. What Types of Companies Have to Worry About Compliance with Section 409A?

All types of companies (i.e., for-profit corporations, both public and private, not-for-profit corporations and governmental entities that sponsor Code Section 457(f) plans, and partnerships and limited liability companies).

8. What Are “Nonqualified Deferred Compensation Plans”?

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation beyond the year in which services are performed. The definition is extremely broad and can include plans or arrangements of the following types:

1. Elective deferred compensation plans (e.g., salary and bonus deferral programs);
2. Non-elective deferred compensation plans (e.g., SERPs);
3. Certain provisions in employment and change in control agreements (e.g., severance upon a termination of employment);
4. Salary continuation plans;
5. Code Section 457(f) arrangements (for non-profit organizations or governmental entities);
6. Certain restricted stock units (RSUs) and phantom stock;
7. Discounted stock options;
8. Certain stock appreciation rights (SARs);
9. Severance plans;
10. Employment agreements/consulting agreements;

11. Medical, disability coverage, including retiree medical benefits;
12. Reimbursement arrangements (e.g., country club dues, car allowance);
13. Certain split-dollar insurance arrangements.

9. Does Section 409A Apply to All “Deferred Compensation Plans”?

No. Section 409A contains grandfather rules and transition provisions that protect certain plans. In general, Section 409A does not apply to amounts deferred prior to December 31, 2004, as long as:

1. The amounts were earned and vested as of December 31, 2004; and
2. The plan or arrangement is not materially modified after October 3, 2004 (except if the modification is to comply with Section 409A).

What constitutes a “material modification” is extensively defined in the Regulations. In general, a modification of a plan is material if a benefit or right existing as of October 3, 2004, is materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned or vested prior to January 1, 2005.

10. Does Section 409A Only Apply to Deferred Compensation Plans Covering Employees?

No. Section 409A also targets plans or arrangements for non-employee directors and certain independent contractors.

11. Are There New Reporting and Withholding Rules As a Result of Section 409A?

Yes. Amounts deferred under a nonqualified deferred compensation plan are subject to reporting and federal income tax withholding requirements at the time they are included in the employee’s income. All deferred amounts must be reported on a W-2 or Form 1099 when deferred, even though the amounts are not yet taxable or includible in income.

12. Is there Any Type of Correction Program or Relief Offered by the IRS?

Yes, the IRS offers a correction program, but it is very limited as to the types of corrections. In general, in order to use the correction program, a 409A violation must be unintentional, must be an operational failure and cannot be egregious or relate to a tax avoidance transaction. An operational failure is a failure to comply with plan provisions or the failure to follow 409A requirements due to an error in operating the plan.

A taxpayer will not incur a penalty under 409A with respect to unintentional operational failures under Section 409A that are corrected by an employer within the employer’s same taxable year. IRS Notice 2007-100 provides specific methods for correcting each type of failure.

13. Why Was 409A Implemented?

The final regulations were in response to legislation enacted by Congress in 2004 to address concerns involving reported abuses of nonqualified deferred compensation plans. This came to the forefront as a result of corporate scandals, such as Enron, and due to companies that are failing and that pay executives deferred compensation in full.

14. Where Can I Obtain Additional Information About Section 409A?

Contact any of the following attorneys.

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