

May, 2006

legal update



underberg & kessler LLP

Section 409A Imposes Harsh Penalties on Some Deferred Compensation Plans

By Scott D. Shimick, Esq.



Qualified deferred compensation plans, such as defined benefits plans and 401(k) plans, allow the employer to take an immediate deduction for the amount of the compensation and, generally, allow the employee to defer including the amount in income until retirement. However, qualified plans must meet strict nondiscriminatory requirements.

While nonqualified plans do not allow for immediate deductions and require the participant to include the compensation in income once the amount is vested, nonqualified plans allow employers to cater to their executives and other highly-compensated employees. Historically, nonqualified deferred compensation plans have also been favored by many employers because of the simplicity of the creation and management of nonqualified plans. However, the management of nonqualified deferred compensation plans was complicated by last year's tax legislation. As part of the American Jobs Creation Act of 2004, Congress created a new Section of the Internal Revenue Code, Section 409A, which governs requirements for such nonqualified plans. While penalties may be avoided for the present if the plan is operated in good faith compliance with the Section 409A rules, the plan must be amended to conform to Section 409A.

The application of Section 409A is not limited to formal nonqualified deferred compensation plans, but applies to any arrangement that provides for the deferral of compensation into a later tax year, with certain exceptions. These exceptions include vacation or sick leave and other compensatory time, disability pay, and death benefit plans. Additionally, Section 409A is not limited to employer/employee compensation arrangements. For example, a business hires an independent contractor who does substantially of their work for the business, but the arrangement between the parties allows for payment on the contract 90 days after the close of the year in which the services are performed. This business may have entered into an arrangement to which Section 409A applies. Additionally, Section 409A applies to service providers that are not natural persons. A nonqualified plan that defers compensation to entities such as personal service corporations must meet the requirements of Section 409A. A nonqualified plan, for purposes of Section 409A, can be any arrangement between a business and either a group of service providers or an individual service provider. The following types of plans should be carefully reviewed to determine if Section 409A applies: Stock options, stock appreciation rights, independent contractor arrangements, separation from employment pay arrangements, split-dollar life insurance arrangements, supplemental employee retirement plans.

The harsh penalties are imposed on any amounts of compensation deferred under a nonqualified plan that does not meet the requirements of Section 409A. All of the compensation deferred under the nonqualified plan must be included in the participant's income, plus interest on the amount included from the time such amount should have been included. Additionally, the participant must pay a 20 percent penalty on this amount. Any amount includible by the participant is wages for purposes of withholding.

Section 409A has three requirements that must be met by nonqualified plans: the distribution requirement, the acceleration of benefits requirement, and the deferrals requirement. First, the distribution requirement provides that the deferred compensation may not be distributed earlier than the participant's separation from service, the date of disability, death, a change in the ownership or control of a substantial portion of the assets of a business, or upon an unforeseen emergency (such as severe financial hardship caused by an accident or illness).

Second, the acceleration of benefits requirement provides that the plan must not provide for acceleration of the time of a payment or the schedule of a payment, except as provided in the regulations. The plan meets the initial deferral election requirement if the plan that allows the participant to elect to defer compensation requires the participant to make the deferral election by the close of the preceding taxable year. If the plan allows for a deferral of performance-based compensation, a bonus, based on services performed over the course of at least one year, then the plan must require the participant to elect deferral no later than six months before the end of the performance period. The plan may allow for the acceleration of benefits under other circumstances, such as a domestic relations order.

Finally, the deferrals requirement provides that a plan that allows a participant to elect a delay in payment or a change in the form of payment must meet the initial deferral decision requirement and the changes in time and form of distribution requirement. The first requirement is met if the plan provides that the participant may elect to defer compensation only before the close of the preceding year. The second requirement is met if the plan requires that such election cannot take effect for at least one year, the first payment under a subsequent election must be deferred for at least five years from the date the payment would have been made, and elections for payments to be made on a schedule may not be made more than one year before the first scheduled payment.

A plan may avoid the Section 409A penalties without strict compliance if the plan is operated through December 31, 2005 with good faith in complying with Section 409A, and other IRS guidance, and if the plan is amended to meet the requirements of Section 409A before January 1, 2006.

If Section 409A may apply to your plan, contact Scott Shimick or your Underberg & Kessler attorney.