Deferred Compensation

Rules Changing; Policy Review Needed

By Alexander L. Mounts

In 2004, Congress amended the Internal Revenue Code to address actual and perceived abusive practices involving deferred compensation arrangements. While the Internal Revenue Service (IRS) had been making its case against certain arrangements for years, it wasn't until abuses in Enron and WorldCom were exposed that action occurred.

A new Code Section 409A was added to provide more concrete rules and boundaries to govern the deferral of compensation. Section 409A appears narrow on its face, but includes a very broad definition of what constitutes "deferred compensation" and has reached its tentacles into many arrangements not historically considered to be deferred compensation.

The trap for most companies and organizations comes as they hear about new rules on deferred compensation and think they do not apply to them. They may be right, but likely are not. In addition to obvious deferred compensation arrangements like executive and director deferred compensation plans and supplemental executive retirement plans, some examples of arrangements which may now provide deferred compensation include employment agreements, severance agreements, change of control agreements, bonus plans, nonqualified stock option plans, stock appreciation rights plans, performance share plans, buy-sell agreements and subscription agreements.

A few exemptions

The IRS has defined deferred compensation to mean a legally binding right to receive compensation that is earned or accrued in one year, but that is paid in another year unless Section 409A says otherwise. Things like payroll paid within a short time following the end of the year, qualified retirement plans (i.e. 401(k), 403(b), 457(b), ESOP and pension plans) and certain welfare benefits (i.e. sick leave compensatory time, vacation leave, disability pay, death benefit plans, Archer medical savings accounts, health savings accounts or any other medical reimbursement arrangement) are exempt from the definition of deferred compensation.

In addition, amounts that are paid within 2½ months of the individual's or employer's tax year following the tax year in which the amount became vested are also exempt from the definition. For example, assume a plan in which a bonus will be paid to an individual for a calendar year provided that certain goals are met. If the goals are met, the payment becomes vested as of the end of the calendar year. If payment is made on or before March 15, it is not deferred compensation. However, if payment is made after March 15, the bonus is deferred compensation and must comply with the requirements of Section 409A.

Time to act

Currently, the IRS has issued proposed regulations, with final regulations expected in the fall, outlining the new rules that govern deferred compensation. Companies and organizations have until December 31, 2006 to bring any arrangement subject to Section 409A into compliance.

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If an arrangement is subject to the new rules and is not amended by December 31, 2006, then a violation will occur and the following penalties will be imposed: (1) all amounts "deferred" will be immediately includible in the employee's income; (2) an additional underpayment interest penalty equal to the quarterly federal short-term rate plus 4% (this is 8.9% as of June 2006) from the date the amount was first deferred or no longer subject to a substantial risk of forfeiture; and (3) an additional 20% income tax on all amounts deferred. According to Section 409A, the employee, not the employer, bears the burden of this tax liability. The following is a penalty calculation assuming an individual "defers" $100,000 in year one and a violation of Section 409A occurs in year two.

Combined State and Federal Income Tax	$100,000	40%	$40,000
Underpayment Penalty	$40,000	8.9%	$3,560
Additional Income Tax	$100,000	20%	$20,000
Total Tax			**$63,560**

Some companies and organizations may ask why they should care about Section 409A given that the employee pays this tax. Rest assured that any employee who receives a tax bill from the IRS is going to head straight to his or her employer and want to know what it is about. The conversation will likely be followed up with a lawsuit for breach of contract for failing to amend or operate the agreement in accordance with law.

It is crucial that companies and organizations act immediately to inventory their agreements, plans and arrangements to determine if they contain any type of payments that could be classified as "deferred compensation" for Section 409A purposes. The arrangements will need to be reviewed and amended, as necessary, by the end of 2006 to comply, or avoid the need to comply, with Section 409A. A compliance review is a small price to pay in relation to the potential consequences.

INFORMATION LINK

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