

409A and You

The Rules Are Changing, So Beware of Costly Non-compliance Penalties

By DENNIS G. EGAN Jr., Esq.

As spring draws to a close and attention turns toward picnics, barbecues, and ballgames, the clock continues to tick down — to Dec. 31, 2008.

While many people associate New Year's Eve with parties and revelry, 2009 will not be a happy year for employees or employers if the non-qualified deferred compensation arrangements and/or plans to which they are a party do not comply with section 409A of the Internal Revenue Code. All businesses — big and small, public and private, non-profit and for-profit — as well as the workers they employ, may be affected by the requirements of and penalties imposed by 409A.

Section 409A was added to the Internal Revenue code as a result of the enactment of the American Jobs Creation Act of 2004. The impact of this addition is far-reaching and not yet fully appreciated. In fact, if you or your employees participate in a deferred compensation agreement or are a party to an employment or severance agreement that provides for deferred payments, you may be subject to the consequences of non-compliance.

What, you may ask, are the consequences of non-compliance? The penalties are as straightforward as they are harsh. If a plan, arrangement, or agreement does not meet the exacting standards of 409A, the amount deferred will be included in the employee's income immediately, even if the employee is not currently eligible to receive that amount. In addition, a penalty tax of 20% will be levied on the amount included in the employee's income.

Finally, an interest payment equal to the IRS underpayment rate plus 1% will be applied from the date when the amount was first deferred to the date when it is includable as income to the employee. Taken together with the income taxes you currently pay, these penalties and interest may equal a 50% tax on your income.

Perhaps the best way to explain the application of 409A is to discuss the plans it does *not* apply to. For instance, the provision does not apply to qualified retirement plans, such as plans promulgated under Internal Revenue Code sections 401(k), 457(b), and 403(b), nor does it apply to defined benefit pension plans, employee stock option plans, vacation pay, sick pay, death and disability plans, or compensatory time off, and other similar plans. While this may seem like an exhaustive list of retirement plans and benefits, it does not include supplemental employee retirement plans, employment agreements, severance agreements, some split dollar arrangements, stock option plans, and other similar plans.

To further complicate matters, non-qualified deferred compensation that was vested prior to 2005 is not subject to 409A because of its 'grandfathering' provisions. Employers with plans that contain compensation deferred prior to 2005 can choose one of a number of options to preserve the grandfathered status of these deferrals. These options include:

- Freezing the existing plan;
- Grandfathering past deferrals while ensuring compliance of new deferrals; and

- Amending the plan in its entirety so as to ensure compliance.

Generally, in order to comply with 409A, a plan and/or arrangement must:

- Place limitations on when an employee may choose whether or not to defer compensation, if applicable;
- Clearly identify when an employee may receive deferred compensation; and
- Place limitations on when a change may be made to the payment date.

Elections to defer compensation for services performed during a taxable year must be made by the end of the year immediately preceding that taxable year. This election must include the time and form of payment to which the employee is eligible.

The limits imposed by 409A on when deferred payments can be received dictate that, in order for a plan or arrangement to comply, it must provide that payments under the plan or arrangement be paid (1) on a date certain; (2) pursuant to a set schedule; and (3) upon the occurrence of a 'triggering event.' These triggering events include separation from service, death, disability, change of ownership, or unforeseeable emergency. If your plan is subject to 409A and doesn't contain the aforementioned conditions, it is now time to begin your 409A compliance program.

The best way to avoid running afoul of the rules set forth under 409A is to put a comprehensive plan in place as follows:

- Identify those plans, agreements and/or arrangements that are subject to 409A;
- Determine who within your

organization is responsible for 409A compliance. If your organization does not have an in-house compliance coordinator, you should contact your accountant, attorney, tax advisor, or human resources professional;

- Evaluate those plans, arrangements, and/or agreements subject to 409A in order to determine whether they are compliant as currently written; and

- Formulate a plan of action to ensure compliance. Steps may include amending, terminating, or adopting new non-qualified deferred-compensation plans.

Section 409A compliance is a complicated and far-reaching endeavor. In order to avoid running afoul of the regulations set forth by 409A, employers should consult with professionals. Several IRS guidance notices have already been written, and more are sure to follow as the effects of 409A are further understood.

The issues addressed here are merely a sampling of the plans affected by 409A and the options available to employers in order to ensure compliance with its rules. As such, do not wait until summer turns to fall before evaluating the deferred compensation plans to which you are a party. Dec. 31 is the deadline to comply with 409A, and non-compliance is going to result in costly fees and penalties in 2009.❖

Dennis G. Egan Jr. is an associate with the regional law firm of Bacon Wilson, P.C., specializing in business and corporate law; degan@baconwilson.com; (413) 781-0560.