Executives and Others Face Tough Tax Liability Unless Deferred Compensation Deals Timely Updated For New Internal Revenue Code Section 409A Compliance

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American businesses and their employees and other service providers frequently participate in employment or settlement agreements, incentive compensation, deferred compensation plans or other deferred compensation arrangements that defer payment of compensation for services performed in one taxable year until a later year. Parties sponsoring or entitled to receive compensation under these deferred compensation plan need to act promptly to evaluate the implications of new Internal Revenue Code ("Code") § 409A upon such arrangements to avoid unintentionally triggering harsh tax consequences for employee or service provider entitled to receive the compensation.

On October 22, 2007, the Internal Revenue Service ("IRS") granted employers additional time to finish updating "deferred compensation plans" covered by Code § 409A to comply with the broad reaching provisions of § 409A. While providing welcome breathing room, most businesses and employees involved in deferred compensation arrangements covered by Code § 409A still will need to act expeditiously to ensure that necessary arrangements to update their particular deferred compensation arrangements are timely completed.

Enacted to curb perceived abuses related deferred pay and other compensation arrangements for high-ranking executives, Section 409A essentially regulates any arrangement that defers compensation other than those specifically exempt from its provisions. Code § 409A defines "deferred compensation plan" broadly to reach to a wide range of practices and arrangements. Because of the broad definition of "deferred compensation plan" employed by Code 409A, it impacts virtually all types of pay and compensation practices that operate to defer the payment of compensation beyond the tax year of the taxable year of the performance of services giving raise to the compensation right. As defined by Code § 409A an arrangement generally provides for the deferral of compensation if, under the terms of the plan or other arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. Accordingly, Section 409A impacts deferred compensation and pay arrangements established pursuant to formal deferred compensation plans, as well as those created by employment agreements, severance agreements, settlement agreements, certain bonus agreements, change of control and other corporate transactions, and a host of other contexts.

Until October 22, 2007, businesses and employees faced a December 31, 2007 deadline to update deferred compensation plans to comply with Code § 409A. In Notice 2007-86, however, the IRS granted additional time for employers to finish updating deferred compensation plans subject to Code § 409A to comply with from December 31, 2007 to December 31, 2008, provided that the arrangements are operated in good faith operational compliance with final regulations published earlier this year for the period from January 1 to December 31, 2008.

Added to the Code by Section 885 of the American Jobs Creation Act of 2004 (the “Act”) and applicable to virtually all nonqualified deferred compensation practices, plans and arrangements, Code § 409A will impose punitive tax consequences upon employees and other service providers entitled to receive deferred compensation under a deferred compensation plan or other covered deferral arrangement unless the arrangement either meets the requirements of § 409A or otherwise qualifies as exempt from its provisions. If a deferred compensation arrangement does not comply with Code § 409A or otherwise qualify as exempt from its provisions, the employee or other service provider earning the compensation immediately incur the following liability to the IRS:

- Income tax on all amounts deferred under the arrangements regardless of whether the taxpayer is entitled to payment of that compensation at that time;
- A 20% penalty tax; and
- Interest is assessed at a “nonpayer rate” (which is higher than that imposed for other violations) plus 1% from the date or dates of deferral.

This liability will arise in the year that the employee obtains a right to receive the compensation that is not subject to a substantial risk of forfeiture regardless of whether the employee in fact then has a right to receive the compensation or whether the arrangement otherwise meets applicable requirements to qualify for deferred taxation under other relevant provisions of the Code.

Furthermore, if the employer seeks to protect an affected employee from the taxes and penalty by making tax protection payments to cover the tax liability triggered by Code § 409A, Code § 409A will bar the employer from deducting the tax protection payments and impose additional excise tax liability equal to 20% of the amount of any such tax-protection payment on the recipient employee or other service provider.

Final regulations construing Code § 409A exempt various compensation arrangements from its provisions. Employers planning to treat one or more compensation arrangements as exempt from the Section 409A mandates beware, however. While the IRS granted additional time for employers to bring covered deferred compensation arrangements into compliance with § 409A, the guidance does not grant additional time to redesign existing programs to qualify as exempt from § 409A. Therefore, employers desiring to treat any deferred compensation arrangements as exempt from Section 409A should act quickly to ensure that that those compensation arrangements intended to qualify as exempt meet all of the conditions for exemption by December 31, 2007.

Some of the more notable highlights of Notice 2007-86 include the following:

- Employers have until December 31, 2008 to amend plans and arrangements to comply with § 409A and the final regulations, including the specification of the time and form of payment;

- Nonqualified deferred compensation arrangements subject to § 409A must operationally comply with § 409A on a reasonable, good faith basis based on the statute and any generally applicable guidance issued through December 31, 2008;

- Until January 1, 2008, the IRS will not require compliance with either the QACA Rule issued in October 2005 or the final regulations but will treat compliance with either guidance as reasonable, good faith compliance; After January 1, 2008, however, reliance on the QACA Rule will no longer be permitted;

- The reasonable, good faith standard will be treated as violated if the employer exercises discretion under a plan in a manner that causes the plan to fail to meet the requirements of § 409A;
- Plans may permit changes to existing elections as to the form and time of payments through December 31, 2008 provided that such changes made in 2008 can't apply to amounts that would otherwise be payable in 2008 or cause an amount to be paid in 2008 that would otherwise not be payable in 2008;
- Payment elections under a nonqualified deferred compensation plan may still be linked to elections under a qualified retirement plans, a § 403(b) annuities, § 457(b) eligible plans or certain foreign broad-based retirement plans through December 31, 2008;
- The Notice extends the relief set forth in Notice 2005-1 and the preamble of the QACA Rule that permitted the substitution of nondiscounted stock options or SARs for discounted stock options or SARs to allow before December 31, 2008 the replacement of a stock option or SAR that otherwise provides for a deferral of compensation under § 409A with a stock option or SAR that satisfies the criteria for exemption from the application of § 409A subject to fulfillment of certain specific conditions; and
- The Notice affirms the IRS plans to establish a program for correcting certain § 409A errors in the near future.

Accordingly, to avoid triggering unintentionally the punitive tax penalties of § 409A, employers should continue to move expeditiously to identify all arrangements potentially impacted by Code § 409A and to act to redesign and redeploy those arrangements either to comply with Code § 409A, to qualify for exemption from its provision, or to otherwise to assess and report tax as required to comply with Code § 409A. To this end, employers and employees or other service providers involved in these arrangements that have not already done so should take prompt action to:

- Inventory all compensation and pay arrangements to identify those that may provide "deferred compensation;"
- Identify those arrangement subject to the Section 409A rules and those that may qualify as exempt under the final regulations;
- Assess the extent to which each applicable deferred compensation arrangement in form and operation complies with the requirements of § 409 or, where applicable, the conditions for exemption;
- Act promptly to implement any corrections necessary to preserve any desired ability to treat a deferred compensation arrangement as exempt from Code § 409A before December 31, 2007, pending further guidance;
- Administer all covered deferred compensation arrangements to comply with Code § 409A after December 31, 2007;
- Timely amend all covered deferred compensation arrangements to comply with Code § 409A by December 31, 2008; and

- Operate all programs potentially covered by Code § 409A in operational compliance with the final regulations published earlier this year.