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Executive Compensation Law Alert

A Corporate Department Publication

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OT: One More Year to Protect Certain Executive Compensation Plans from Tax Penalties

Since its introduction in 2004, Internal Revenue Code Section 409A, which governs nonqualified deferred compensation plans, has generated both confusion and worry. Confusion has resulted from the broad reach of the phrase "nonqualified deferred compensation," which refers generally to any compensation that is earned in one year but paid in another and is not governed by the Employee Retirement and Income Security Act (ERISA). Worry has resulted due to Section 409A's potential penalties on nonqualified deferred compensation arrangements that do not satisfy strict election and payment timing rules: current taxation for deferred income, a 20 percent penalty, and interest payments.

I. Identification of Arrangements That May Be Subject to 409A

It's not, however, too late to correct many of the more common compliance mistakes under Section 409A. The first step is to identify any plans or agreements that were signed in one year but will pay compensation in a future year. Section 409A may well apply to any arrangements that fit that description and should be evaluated with that in mind. Such plans could include employment agreements, severance agreements, change in control agreements, expense reimbursement plans, and equity compensation plans in addition to traditional nonqualified plans, such as non-ERISA retirement plans.

II. Key 409A Compliance Rules

Once all nonqualified deferred compensation agreements have been identified, the next step is for both employers and employees to check for compliance with three main rules (or the availability of exceptions to these rules):

1. **Election Timing Rule:** Elections to defer compensation generally must be made by December 31st of the year before the calendar year in which services are performed.

2. **Time and Form of Payment Rule:** All plans or agreements with deferred compensation must specify the time and form of payment in the document. Accelerations of payment and delays in payment generally are prohibited.

3. **Six-Month Delay Rule (applies only to key employees of public companies):** Key employees of public companies generally may not receive their first severance payment until six months after their termination date. "Key Employees" are defined in regulations under Section 409A and generally include the 50 highest paid officers of a company who earn more than $160,000 a year.

III. Calculation of Penalties Upon Violation of 409A

If a plan's terms violate Section 409A, the employer must report the total amount deferred in the year the violation is discovered and in all prior years in which there was a violation. This amount is taxed at ordinary income tax rates with an additional 20 percent penalty tax plus a premium interest tax. The premium interest applies to the tax underpayment that results from failure to include deferred amounts in taxable income for the years in which there was a violation. Not surprisingly, these penalties — particularly the premium interest — can be quite burdensome to employees.

IV. Reporting and Withholding Requirements

Employees are responsible for paying the 20 percent penalty and premium interest, but employers have wage reporting and withholding requirements when violations of IRC Section 409A occur. For employees, an employer must report amounts includable in income on Form W-2 using Code Z. If a violation occurred in a prior year, the employer must issue a W-2c and withhold the amount of the under-payment. The employer determines the amount of tax to deduct and withhold using supplemental wage rates, even if the employer has not paid regular wages to the employees. The employer is not required to deduct and withhold the 20 percent penalty tax or premium interest tax. As such, employees may be required to make estimated tax payments to avoid additional penalties.

For non-employees, payers should report amounts that violate IRC Section 409A on Form 1099-MISC in Box 7 and Box 15. Non-employees also may need to make estimated tax payments to avoid additional penalties.

V. Relief from 409A Penalties

If the plan terms comply with Section 409A, the IRS and Treasury have given both employers and employees until December 31, 2009 to bring the manner in which those plans are administered into compliance in many cases. If administrative errors are corrected in the year in which the errors were made, the penalties described above generally will not apply. For non-insider employees, even more time may be available to make necessary corrections, and this relief will apply in 2009 even if the error occurred before 2008.

To be eligible for this relief, the employer must take commercially reasonable steps to ensure that the mistake does not happen again. Further, both the error and the correction method must be disclosed to the IRS.

VI. Action Items

To minimize the risk of violating Section 409A, employers and employees should take the following steps:

1. Check deferral election forms for compliance with the Election Timing Rule.
2. Identify key employees each year (public companies only). Make any amendments necessary to comply with the Six-Month Delay Rule or qualify for an exception to avoid immediate penalties on severance payments that have not yet been triggered by termination.
3. Determine whether administrative violations of Section 409A have occurred and, if so, take steps to correct them. In particular, employers should review past deferral elections and payments to see if the proper amounts of compensation have been withheld from employees and deferred. Alternatively, employers should determine whether payments have been made in a timely manner.
4. Maintain written records of steps taken both to prevent and correct errors.
5. Communicate with plan administrators and participants to explain the basic rules under Section 409A and the importance of compliance.

The IRS has stressed that the key to compliance with Section 409A is training and documentation. Effective training and documentation now could yield savings in unnecessary taxes, penalties, and interest in the future.

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