Last Chance to Avoid §409A Penalty Taxation on Deferred Compensation

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The IRS has recently extended the deadline for bringing deferred compensation plans into compliance with §409A. Section 409A of the federal tax code imposes harsh tax penalties unless certain steps are taken. **To avoid inadvertently triggering §409A tax, all plans of deferred compensation must be reviewed and, if necessary, revised before the end of 2008.** After 2008, existing plans of deferred compensation cannot be amended to comply with 409A.

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PENALTY

The tax penalty imposed by §409A on the recipients of certain deferred compensation consists of: (a) accelerated income taxation on the deferred compensation; (b) interest; and (c) a penalty equal to 20% of the amount included in gross income.

PLANS AFFECTED

The type of arrangement that is subject to this tax penalty is one which offers compensation that becomes legally binding in one year and payable in a future year at a time that is not restricted to certain triggers. The sweep of §409A is very broad. For example, discounted stock options or stock appreciation rights can trigger §409A. Section 409A also applies to deferred payments in connection with non-compete agreements, certain severance pay arrangements, nonqualified deferred compensation plans, employment agreements with deferred payments, §457(f) arrangements, releases involving deferred compensation and some bonuses.

EXCLUDED ARRANGEMENTS

Certain types of deferred compensation are excluded from the reach of §409A such as payments under qualified retirement plans, IRAs, foreign plans, §403(b) and §457(b) plans, incentive stock options and other non-discounted stock options or stock appreciation rights, and certain severance arrangements, to name a few. Certain educational benefits and settlements in employment litigation relating to wrongful termination, discrimination, the FSLA or worker's compensation are also exempt from §409A. However, the rules in this area have a number of subtleties. For example, to be excluded from §409A, severance pay must be no more than the lesser of twice the employee's pay, or a statutory dollar limit ($450,000 for 2007). In addition, the severance must be paid in full within two years following the employee's involuntary layoff or termination for a good reason, as defined by law. Payments to retiring partners or a deceased partner's successor are generally not subject to §409A unless they meet the exception from self-employment taxes under §1402(a)(10).

PLAN OPERATION CAN TRIGGER TAX

Certain payment provisions relating to deferred compensation can trigger §409A. For example, a common provision in a deferred compensation plan that triggers §409A is one that gives discretion to determine the time or manner of payment; such as an election to make payments in either a lump sum or in installments. Eliminating choices in the timing and manner of payment is necessary to avoid penalty taxation. However, until the plan is amended, discretion in the timing or form of payments should not be exercised.

BOTTOM LINE

To avoid potentially punitive tax results on deferred compensation these arrangements must be reviewed as soon as possible, and, if necessary, amended before December 31, 2008. In the meantime, plans must be operated to comply with §409A.

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Evelyn Haralampu oversees Burns & Levinson's employee benefits/ERISA practice. She is also a member of the Tax, Corporate, Private Client and Labor, Employment and Employee Benefits Groups. Ms. Haralampu has extensive experience advising both businesses and non-profit entities. In particular, she counsels on employee benefits design, executive compensation programs, equity-based compensation, health care privacy, employment law, immigration and tax related issues. She assists employers with benefits and executive compensation issues in the context of corporate reorganizations, bankruptcies and succession planning. She also counsels individuals on estate planning issues and property settlements in divorce. Ms. Haralampu represents clients before the Internal Revenue Service and U.S. Department of Labor, and counsels on ERISA controversies in the federal courts.

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