Deferred Compensation Changes

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There is now a final date for requirements that apply to nonqualified deferred compensation (NQDC) plans under IRS Code Section 409A. The 409A requirements have been in effect since the beginning of 2005, but the IRS has now issued final regulations which are generally effective January 1, 2008.

The costs of noncompliance are high. All amounts deferred under a noncompliant NQDC plan are included in the employee's taxable income. Interest is also imposed on the taxes due, and, on top of that, a 20% penalty is imposed. While these sanctions fall on the employee, their impact will be felt by the employer, either through an indemnification agreement or employee dissatisfaction.

In order to comply with 409A, the employer must first examine all of its compensation plans to determine whether they involve deferred compensation. Any arrangement provides for deferral of compensation if the employee has a legally binding right to compensation that is payable in a later tax year. Even if the legally binding right is subject to a later condition, such as the requirement that the employee continue to work for the employer until a future date, the compensation is still considered deferred compensation.

Certain plans enjoy an exemption from the 409A requirements. Qualified retirement plans, tax-deferred annuities, simplified employee pensions (SEPs), and SIMPLE retirement accounts aren't considered NQDC plans. Also, 409A doesn't apply to most welfare benefit plans, such as bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans. In addition, incentive stock options, nonstatutory stock options and stock appreciation rights (SARs) on employer stock don't provide for deferral of compensation if the option or SAR isn't in the money on the date of grant and there is no other feature for deferral of compensation.

If it is determined that 409A applies to a plan, you will need to make sure that the plan complies with the 409A requirements. The general requirements relate to: (1) the initial deferral election, (2) the timing of payments, (3) acceleration of payments, and (4) later deferral elections or amendments. Each of these requirements must be spelled out in a written plan document, and the plan must be operated in accordance with them.

Generally, an employee must make the initial election to defer compensation before the year in which the services are performed. In an employee's first year of eligibility, he or she may make a deferral election in the first 30 days of participation, but the election may apply only to compensation earned after the election was made.

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An election to defer performance-based compensation that is based on services performed over 12 months or more must be made no later than six months before the end of the performance period.

Payments under a NQDC plan must be made at a fixed date, under a fixed schedule, or upon any of these five events: separation from service, death, disability, change in ownership or control of the corporation, or unforeseeable emergency. If the timing of payment is based on a specified event, the plan must designate an objectively determinable date or year after the event on which payment is to be made.

Payments of deferred compensation generally may not be accelerated. The IRS has provided only limited exceptions to this rule, such as for payments necessary to comply with a domestic relations order, payments necessary to comply with conflict-of-interest rules, and certain payments upon plan terminations. 409A specifically prohibits "haircut" provisions, under which a participant may take payments at any time, subject to a reduction in amount.

If a NQDC plan permits an employee to elect to delay or change the form of a payment, the following conditions must be met: (i) the election may not take effect until at least 12 months after the date on which it was made, (ii) if the election relates to a payment that is not on account of death, disability or unforeseeable emergency, the first payment for which the election is made must be deferred for at least five years; and (iii) any election related to a payment at a specified time or under a fixed schedule may not be made less than 12 months before the date of the first scheduled payment.

As indicated earlier, the final 409A regulations are effective January 1, 2008. Generally, a NQDC plan must provide in writing the time and form of payment by December 31,2007. If the time and form of payment are not in compliance with 409A or if it is otherwise desirable to change the time or form of payment, the plan may be amended to provide for new payment elections on or before December 31, 2007. If the amendment and elections are made on or before December 31, 2007, they will not violate the rules against changes or acceleration provided in 409A. Following January 1, 2008, a NQDC must be operated in accordance with 409A and all remaining provisions of the plan must be amended in writing to be in compliance with 409A by December 31, 2008.