

D&G Legal Development Alert: Executive Compensation & Employee Benefits

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WHY YOU NEED TO CARE ABOUT SECTION 409A

Why do employers and employees need to care about Section 409A – the sweeping legislation that affects non-qualified deferred compensation plans? The answer is this: if a deferred compensation plan is not amended to comply with Section 409A by December 31, 2008, all deferrals under the plan may be penalized and subject to taxation before they are distributed.

But if you don't have a deferred compensation plan, then you don't need to worry about anything, right? Correct, but only if you're sure that you don't have a deferred compensation plan. Section 409A applies to more than just traditional deferred compensation arrangements, such as SERPs and bonus deferral plans. It also may apply to stock option plans, phantom stock plans, restricted unit plans, long-term incentive plans, employment agreements, severance agreements and change in control agreements, among others. Basically, Section 409A is at issue any time a legally binding commitment is made to pay compensation in a future year.

Overview of Section 409A

Section 409A overhauls the rules governing deferred compensation plans much in the same as ERISA completely rewrote federal pension law in 1974. It became effective with respect to deferrals made on or after January 1, 2005 and good-faith compliance is currently required. Full compliance with Section 409A and its final regulations is mandated beginning January 1, 2009.

The requirements imposed by Section 409A on deferred compensation plans are numerous.

Some of these requirements are as follows:

- Deferred compensation may be distributed only upon separation from service, death, disability, change in control, unforeseeable financial emergency, or at a time specified by the arrangement or according to a fixed schedule.

- In the case of a “specified employee” (sometimes referred to as a “key employee”) of a public company, a distribution on account of the employee’s separation from service must be delayed for six months after the separation.
- An election to defer compensation earned during a calendar year must be made before the beginning of that year, although certain exceptions apply such as in the case of “performance-based compensation.” The deferral election must also specify the manner and time of payment.
- Once an amount has been deferred there are limitations on the ability to change the manner and time of payment.
- With limited exceptions, a deferred compensation plan may not permit acceleration of the time or schedule of payment.

Although these requirements may seem simple on their face, they are often very difficult to apply to all but the simplest deferred compensation plans. Often it is best to create an arrangement that is exempt from these requirements. However, the exemptions under Section 409A can get nearly as complex as the rules.

Penalties

Likely the most important reason to pay attention to Section 409A is the monetary penalties for noncompliance. If a person has deferred compensation that is not compliant with Section 409A, the deferral will be subject to a 20 percent tax penalty, and interest at the underpayment rate plus 1 percent. Along with ordinary income taxes, these penalties could make the person’s deferred compensation taxable at a rate of nearly 60 percent. Also, these taxes apply whether or not a distribution has been made from the plan.

Action Items for 2008

To get into compliance with Section 409A, you’ll need to review and amend your deferred compensation plans before December 31, 2008. Here are some specific action items:

- Review all arrangements that provide compensation, including employment agreements, offer letters, bonus programs and severance policies, to ascertain whether they are subject to Section 409A.

- Amend those arrangements that are subject to Section 409A to comply with the requirements of Section 409A, or amend such arrangements so that they fall within an exemption from Section 409A.
- Review administrative procedures to make sure they are compliant with Section 409A.
- Under transition rules that expire at the end of 2008, the manner and timing of payments under a deferred compensation may be changed. However, no payment may be accelerated to 2008 and no payment due in 2008 may be delayed.
- Review all stock option grants and take appropriate action to fix options granted at a discount.

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