You've Been Warned: Living with the New Rules under 409A

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In the wake of the expiration of the December 31, 2008 amendment deadline for deferred compensation plans to ensure that the terms of the plans or arrangements comply with the requirements of Internal Revenue Code (IRC) section 409A, employers must now begin to comply with the operational and reporting obligations of the law.

Enron Sparked Passage of Law Governing Deferred Compensation

Much like the enactment of the Employee Retirement Income Security Act (ERISA) in response to Studebaker-Packard's default on its retirement obligations to its workers when that company failed, Section 409A was enacted in 2004 in the wake of Enron's collapse. Section 409A codifies guidelines on deferred compensation. In recent years, much of the significant compensation paid to key executives has been in the form of deferred compensation, such as parachute payments and non-qualified supplemental executive retirement plans. The Internal Revenue Service has long been interested in governing these types of arrangements to ensure proper taxation. However, in enacting Section 409A, Congress went farther than simply protecting the tax collection interests of the government and restricted most payment accelerations under deferred compensation payments. The reason for such provisions was to avoid another Enron situation of insiders being able to accelerate payments of compensation to themselves while allowing rank and file employees and investors to suffer losses.

General Overview of Section 409A

Of course, Section 409A goes beyond the situations presented in the Enron collapse and restricts the design and operation of virtually every compensation arrangement in which amounts are paid to workers years after the time when the payments were earned. Thus, absent exceptions built into Section 409A, all severance pay, phantom and actual stock options, stock appreciation rights, deferred compensation plans and other similar compensation arrangements are governed by this new law.

To comply, plans must only allow payments to commence as a result of one of six permissible triggers: separation from service, change of control, death, disability, unforeseeable emergency, or in accordance with a pre-set schedule of payment dates. All of these terms have strict definitions which must be used. Notably, termination of the plan is not one of the permitted payment triggers; nor is renegotiation of the contract. A payment method per trigger (such as a lump sum payment or installment payment) must be established by the plan document. Once a payment method is set, it cannot be changed except that it may be deferred for at least five additional years if the further deferral is elected on a timely basis in accordance with the terms of Section 409A, which requires that the additional deferral election be made at least twelve months before the payment was due to begin. With respect to certain key employees of publicly traded companies known as "specified employees," no payment can be made upon separation from service until a waiting period of six months from the date of separation unless the employee dies. With respect to deferred compensation plans in which participants elect to defer compensation, Section 409A restricts the timing of the deferral elections. For deferred compensation plans which "mirror" or are otherwise linked to qualified Section 401(k) plans, the non-qualified plans have to ensure that the amount of the deferral is unaffected by the 401(k) plan and that payments from the mirror plans cannot be triggered by any event other than those permitted by Section 409A.

Consequences of Violating Section 409A

Violation of the law causes adverse tax effects to the employee or independent contractor (referred to in the law as the "service provider.") First, the law imposes a 20% excise tax on the deferred compensation which does not comply with the law. Second, the offending compensation is included in the taxpayer's income when the service provider became vested in the amounts (i.e. once the compensation was no longer subject to a substantial risk of forfeiture.) This means that, once a taxpayer has a contractual right to receive a payment upon a trigger event, the amount could become taxable in that year even though the trigger event has not yet occurred. For instance, if an executive executes an employment agreement that promises a severance payment of normal pay for five years after separation from service regardless of the reason for the separation, and the payment arrangement does not comply with Section 409A, an amount equal to the present value of five years of pay is taxable in the year in which the executive signs the agreement. Note that this arrangement may comply with Section 409A. One way in which the arrangement could fail, though, is if the severance payment is due even if the executive continues to work for the company after the "separation" date such as in another employment capacity or as an independent contractor.

Reporting and Withholding for Amounts Includible in Gross Income under Section 409A

The Internal Revenue Service has published proposed regulations and Notice 2008-115 to provide guidance on how this tax should be computed and paid. The amount of deferred compensation that is includible in gross income under Section 409A(a) and that is required to be reported is any amount of deferred compensation that is actually paid or made available to the individual under the plan during the year, plus, if the plan fails to meet the requirements of Section 409A, the portion of any additional amount deferred under the plan that, as of December 31 of the year, is not subject to a "substantial risk of forfeiture" and has not already been included in income. To determine when tax withholding amounts should be deposited, taxable amounts are treated as having been paid as of the date on which they are either actually or constructively received, or, if not actually or constructively received during the year, on December 31 of that year.

The additional tax that is due as a result of a failure of Section 409A is the twenty percent penalty plus interest due as if the amount had been included in income in the earlier year or years in which the service provider became vested in the amount due. In addition, the interest is calculated using a premium interest rate. For purposes of the calculation of the additional tax, amounts that were originally deferred before 2005, but which became subject to section 409A due to a material modification of the plan after October 3, 2004, may be treated as having been deferred on January 1, 2005.

Once it is determined that the tax is due, in the case of an employee, the amounts includible in gross income under Section 409A are reportable as "wages" in box 1 of Form W-2, and in box 12 using code "Z." These amounts are treated as "supplemental wages" for purposes of determining the amount required to be withheld regardless of whether the employer has paid the employee any regular wages during the year. However, no additional withholding is required for the additional income taxes that are imposed under section 409A (such as the additional 20% tax which would be due if the amount was due as a result of non-compliance with Section 409A). An employee may, therefore, be required to make estimated tax payments in order to avoid penalties for under-withholding. For nonemployees, any amount includible in gross income under Section 409A that is not treated as wages is reportable as nonemployee compensation in box 7 of Form 1099-MISC and as section 409A income in box 15b.

Reporting Annual Deferrals on Form W-2 or Form 1099-MISC

Section 409A also requires the concurrent reporting of amounts being deferred under a Section 409A deferred compensation plan even though that amount is not yet reportable as income. The instructions for Form W-2 provide that amounts deferred during the year be included in box 12, and identified with code "Y," and, in the case of a non-employee, such deferred amounts are supposed to be reported in box 15a of Form 1099-MISC. However, in Notice 2008-115, this reporting obligation is suspended until further notice, so employers do not yet need to comply with this aspect of the law.

Correction Program for Operational Violations of Section 409A

The Internal Revenue Service has adopted a limited correction program that permits employers that violate the terms of Section 409A to correct certain enumerated operational errors to avoid some of the adverse tax effects of such violation. The new program does not extend the December 31, 2008 deadline for amending plan documents to comply with Section 409A. Thus, if a plan document contains provisions that violate the requirements of Section 409A, the Internal Revenue Service offers no relief from the tax effects of such non-compliance.

Relief is limited (and in certain cases unavailable altogether) for "insiders." For purposes of the new program, insiders include directors, officers and more than 10% beneficial owners of an employer, as determined under Section 16 of the Securities Exchange Act. The limits on insiders apply regardless of whether the employer is publicly or privately held and regardless of whether the employer is a corporation.

To be eligible for the program, the operational failure must be inadvertent and unintentional; the employer must have taken steps to avoid the recurrence of operational failures; the employee's tax return must not be under audit with respect to the plan for the year in which the operational failure occurred; the operational failure must be fully corrected; and the listed requirements in Notice 2009-113 for the particular correction method, including notification obligations, are met. In addition, in light of the current economic downturn, the correction program prohibits correction of erroneous payments to employees if the employer experienced a substantial financial downturn in the year in which the payments were made if the downturn or other financial issue would pose a significant risk that the employer will not be able to pay the amount when due.

The program permits correction of payments that are made too early or too late in violation of plan terms; however, such corrections must be made in the same year as the payment was made if such correction involves insiders. (For non-insiders, relief is available as long as the early or late payment is corrected in the year immediately following the year in which the failure occurred.) The correction method for early payments is to have the service provider repay the employer. To correct a late payment (including, for example, an excess or improper deferral), the employer must repay the service provider. In some cases, the repayment must include interest or earnings. Non-insider employees may get an extension of up to 24 months from their tax return due date if repayment in the same year would cause the employees an immediate and heavy financial need. If correction is made within the same tax year or within the extended period, the taxpayer is relieved from inclusion in income on vesting, the 20% penalty tax, and the premium interest rate.

Under Section 409A, certain stock rights (including stock options and stock appreciation rights) are generally exempt from Section 409A if the exercise price is not less than the fair market value of the underlying shares on the date of grant. The correction program permits employers to modify the exercise price of a discounted stock right to an amount that is not less than the fair market value of the underlying stock on the date of grant. The stock right will be treated as exempt from Section 409A if the exercise price adjustment is made by certain deadlines specified in Notice 2008-113.

The new program also permits certain additional corrections such as specified operational failures involving limited amounts ($16,500 for 2009) and certain early and late payments not corrected within two years; however, the tax relief is less generous. These corrections are subject to the 20% penalty tax but not the premium interest rate under Section 409A. The new program also provides special relief for operational violations occurring before 2008.

An employer relying upon the new correction program must attach a statement to its tax return and furnish a similar statement to affected employees that it is relying on the relief under the program. The guidance sets forth specific information that must be included in the statements. No statements are required to be filed or furnished for corrections of the exercise price of otherwise exempt stock rights.