

## **DEFERRED COMPENSATION AND SECTION 409A OF THE INTERNAL REVENUE CODE**

### **BACKGROUND**

In recent years, the media has publicized several instances where executives of publicly traded companies received extremely large amounts of money while the companies they ran (and their stock) were rapidly decreasing in value. As a response to this perceived issue, Congress passed Section 409A of the Internal Revenue Code (the "IRC") as part of the American Jobs Creation Act of 2004. Section 409A was intended to deter these deferred compensation plans, and provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years is includible in the recipient's current gross income unless certain requirements are met.

Although 409A became part of the IRC in 2004, the final regulations interpreting Section 409A were published in April of 2007 and were expected to go into effect as of January 1, 2008. However, in response to concerns from businesses and tax practitioners, the IRS extended the deadline for existing documentation to comply with 409A until December 31, 2008. If you are unsure if your current compensation plan complies with Section 409A (and its regulations), please consult a tax professional to see if your plan can be made compliant.

First, we should define deferred compensation. Deferred compensation exists when two parties, typically an employer and employee, agree that the employer will give the employee earnings in a future tax year for services that were performed in the current (or previous) tax year. If the employee does not have a "substantial risk of forfeiture" regarding the future payment, it is probably deferred compensation. However, not all deferred compensation is "nonqualified," and violates 409A. The typical example of a "qualified" deferred compensation plan would be an employer's 401(k) retirement plan. These "qualified" deferred compensation plans do not violate 409A and are not subject to current taxation.

It is also important to note that 409A only applies to deferrals of compensation that are not constructively or actually received within two and a half months of the end of the service provider's tax year. So, if the person receiving the deferred compensation is a calendar year taxpayer, any compensation paid to that person by March 15<sup>th</sup> of the year after they are supposed to receive it would not be considered deferred compensation.

One way to make a deferred compensation agreement comply with 409A is to make the deferred compensation payable only upon certain events. Those events include: an employee's involuntary separation from service, death, disability, or a change in control of the company.

So, what happens if a nonqualified deferred compensation agreement is determined by the IRS to violate Section 409A? The receiver of the compensation would face immediate income tax inclusion of the amount deferred, and may be also liable to the IRS for a 20% tax penalty (plus any applicable interest). Additionally, the payer would be required to pay additional withholding for the deferred compensation amount, and would also be subject to penalties for failing to report and withhold the proper amount.

Even if a particular deferred compensation agreement falls within one of the exceptions listed above, it is possible that an agreement could still run afoul of the complex federal regulations that interpret 409A. Before agreeing to any deferred compensation arrangement, see a tax professional to make sure the agreement does not run afoul of 409A and its regulations.

*This article was written by Paul C. Rudolph, an associate with Rudolph, Fine, Porter & Johnson, LLP in Evansville, Indiana. For additional information, you may contact Paul C. Rudolph at (812) 422-9444 (e-mail:pcr@rfpj.com). His practice areas include probate and estate planning; tax law and corporate and business law.*

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