Overline: Committee Report: Retirement Benefits

Headline:

Section 409A Alert

Deck: Quick, learn to issue spot. If your clients get caught out of compliance, they could be hard hit. Deadline for compliance: Jan. 1, 2008.

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Estate planners need to identify Internal Revenue Code Section 409A issues when advising executives and professionals who participate in "nonqualified deferred compensation plans." The final regulations' effective date—Jan. 1, 2008—is fast approaching and the impact on your clients if the plans in which they participate don't comply could be severe.

Section 409A was added to the Internal Revenue Code by the American Jobs Creation Act of 2004[1]. Since its enactment, Section 409A has been a topic of much detailed and arcane discussion among employee benefits lawyers who design nonqualified deferred compensation arrangements on behalf of service recipient organizations. A lot of work has gone into revising and restructuring employers plans to comply. The Internal Revenue Service also has put great effort into developing comprehensive regulations; the final regs, nearly 400 pages worth, were issued April 17, 2007[2] to be effective January 1, 2008[3] Estate planners do not need to become experts. But they do need a working knowledge so they can identify potential problems.

Affected Plans

The most basic point to know is that Section 409A and the implementing regulations sweep into Section 409A coverage not only the obvious supplemental executive deferred compensation plans, but also many other arrangements that provide "for the deferral of compensation." These Section 409A arrangements may cover employees or other service providers (for example, independent contractors or entities); they may provide or be based upon equity positions in the enterprise; and they may be free standing plans or features of employment agreements or severance pay agreements. Moreover, the service recipients may be almost any type of business, charity or other organization.

If you identify a possible deferral of income in a covered arrangement, there are, thankfully, several important exemptions, including:

- the familiar long list of qualified deferred compensation arrangements;
- stock options with exercise prices equaling or exceeding fair market value on the issue date;
- arrangements covering foreign workers with foreign source income;
- deferrals to early in the following year, based on the organization's normal payment schedule; and
- certain welfare benefit plans, for example those providing solely death or involuntary severance pay.

Currently, there also is an exemption for partnership compensatory arrangements that will be treated as "guaranteed payments" when paid to partners or former partners. The IRS has not indicated whether the partners-guaranteed payments Section 409A exemption is a temporary or long-term feature of the 409A scheme. But I believe it will continue. If it didn't, coordination of Section 409A with partnership taxation would become inordinately complex.

Negative Consequences

When Section 409A covers a deferred compensation arrangement, the general rule is that amounts otherwise deferred are subject to gross income inclusion on the vesting date, which typically is the date on which an employee is no longer required to perform substantial additional services to be entitled to the benefits. Also on that vesting date, there's both a 20 percent additional tax as well as interest from the original date of deferral.

This punitive taxation is most likely to impact the high income executives or professionals who are likely to be clients of estate planners and related advisors.

An example of the potential tax consequences is as follows. Joe Executive enters into a severance agreement with his former employer on February 15, 2008 that provides for Joe to receive $1 million in severance pay over a 5-year payment schedule. However, the agreement also provides that the payments will be accelerated if the former employer's owners withdraw more than $X from the business causing its financial reserves to fall below a specified level. Since the agreement provides for a deferral of compensation, its contingent acceleration provision violates the definite payment schedule requirement (discussed below) and Joe is not required to perform any additional services to be entitled to the benefit, the $1 million of

deferred payments are included in Joe’s 2008 gross income. Further, an additional tax of $200,000 will apply.

While service recipient organizations (whose advisors typically design the arrangements) usually wish to assure advantageous tax treatment for participating individuals, those organizations are impacted only secondarily, by their wage compensation withholding and/or reporting responsibilities; and/or by having unhappy service provider individuals.

Fortunately, 409A’s negative consequences apply only to the individuals for whom Section 409A requirements are not met. Therefore, an individual’s advisor will need to be concerned only with how his client is covered by a deferred compensation arrangement, not with differing provisions for other covered individuals.

Requirements

Section 409A’s general punitive taxation does not apply if an arrangement (as applied to a particular individual) meets requirements pertaining to each of five features of the arrangements:

(1) advance deferral elections;

(2) a definite payment schedule;

(3) minimum deferrals for “specified employees;”

(4) acceleration or additional deferral of payments; and

(5) offshore funding.

Each of these sets of requirements is complex. Indeed, they comprise much of the almost 400 pages of the Section 409A final regulations. Nevertheless, a few observations may help individuals’ advisors spot arrangements that deserve more complete review:

(1) *Advance Deferral Elections*—In general, to meet Section 409A requirements, deferrals must be made, and must be irrevocable, on or before certain dates. For arrangements based on individual service provider elections, deferral elections generally must be made before the service provider’s taxable year in which the applicable services are performed. However, certain later elections are permitted for forfeitable deferrals, in the first year the provider is eligible under the arrangement, for certain short-term deferrals, and for arrangements that operate on a fiscal year different than the provider’s taxable year.

Deferrals that are not made at the service provider's election must be made before the service provider has a legally binding right to the compensation or, if later, the date that would have applied if the service provider had an election right.

(2) *Definite payment schedule*—A Section 409A-compliant arrangement will specify when, to whom and how payments will be made. Specifying dates for such payments is, of course, the most obvious definite payment schedule. However, payments upon the occurrence of specified events also are permissible, including:

• to beneficiaries after the service provider's death;

• the service provider's total and permanent disability; and

• change of control of the service recipient.

(3) *Minimum deferrals for "specified employees"*— "Specified employees," that is to say certain key employees of publicly traded corporations, may not generally be entitled to distributions until they've been separated from service for six months.

(4) *Change in payment schedules*—A Section 409A-compliant arrangement generally will not allow changes to a previously established payment schedule. However, certain changes are permitted, including:

• The service provider may change beneficiaries despite the effect that such changes may have on life expectancy payments after the service provider's death.

• Payments may be made to individuals other than service providers to comply with state domestic relations orders.

• Accelerated payments may be made to eliminate service providers' ties to service recipients if that is necessary to comply with state or federal ethics or conflicts-of-interest rules.

• Payments may be deferred for not less than five years beyond the original payment date if the new deferral election is made at least one year before the originally payment date.

(5) *Offshore Funding*—Section 409A taxes generally apply if assets to fund the deferred payment obligation are moved into a foreign trust or other offshore funding mechanism.

Exceptions apply if the service providers are non-resident aliens who perform their services outside the United States.

Other Tax Rules

Section 409A requirements are imposed along with existing deferred compensation rules, including:

• Possible earlier inclusion of deferred compensation in gross income based on the service provider having constructive receipt and/or an economic benefit.

• If the service recipient is a tax-exempt organization, there is service provider gross income inclusion when benefits become non-forfeitable even without constructive receipt or an economic benefit.

• Payments following the death of the service provider will be income in respect of a decedent; that is to say, the legatees or beneficiaries receiving the payments generally will include the deferred compensation in their gross incomes in the same manner as the service provider would have.

Beware

Section 409A and its recently issued final regulations establish complex and detailed rules that must be followed to avoid punitive tax treatment of many arrangements intended to defer receipt of compensation for both employees and independent contractor service providers. Knowing those rules and properly designing arrangements to comply with them is primarily the responsibility of employee benefits attorneys advising employers and other service recipient organizations. But advisors to executives and other service providers should be able to spot arrangements that need a second expert review because it is their clients who will be directly subject to the punitive taxes. Hopefully, this overview has given you a starting place. But if you have any questions, call an expert. The stakes are too high to do otherwise.

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[1] P.L. 108-357 enacted Oct. 22, 2004.

[2] Final Internal Revenue Service regulations for Internal Revenue Code Section 1.409A-1 through -6 were issued on April 17, 2007; there were 397 pages including the preamble in the version the author printed.

[3] Under the enacting statute, Section 409A is effective for amounts deferred after Dec. 31, 2004. However, IRS rulings allow reasonable good faith compliance prior to final regulations becoming effective. The preamble to the final regulations states that the regs apply to taxable years beginning on or after Jan. 1, 2008.