

10 Things You Need to Know About Section 409A

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As most executives will have heard by now, Section 409A of the Internal Revenue Code changes the legal landscape for any compensation plan or arrangement that promises a benefit in one year and pays the benefit in a later year. Section 409A effectively removes much of the flexibility that previously applied to most forms of deferred compensation.

1. Compliance deadline is December 31, 2008.

By December 31, 2008, all plans and arrangements subject to Section 409A must be in operational and documentary compliance with Section 409A. There is a limited opportunity to use transition relief for the rest of 2008.

2. Penalties apply for non-compliance.

If a plan or arrangement fails to comply with Section 409A, compensation deferred under the plan for that taxable year and all preceding taxable years is immediately included in taxable income (unless subject to a substantial risk of forfeiture). In addition, the amount included in income is subject to a 20 percent excise tax plus an interest penalty. The taxes and penalties are imposed on each participant who is affected by the failure.

3. Deferred compensation is broadly defined.

Deferred compensation exists under Section 409A if an employee acquires a legally binding right to compensation in one year and a legal right to payment of compensation in a later year. For this purpose, conditions that might cause an employee to forfeit the compensation (such as a vesting schedule) do not prevent the employee from acquiring a "legally binding right."

4. Some plans are excluded by statute or regulation.

Section 409A does not apply to:

- Qualified retirement plans.
- Bona fide vacation, sick leave, disability and death benefit plans.
- Non-taxable health arrangements, such as retiree medical (if non-discriminatory).
- Short-term deferrals generally payment must be completed within 2 months after end of calendar year (or employer's fiscal year) in which substantial risk of forfeiture lapses.
- Certain severance plans, generally those involving involuntary termination.

- Stock options that do not provide for deferral of compensation. (Generally, discounted stock options are subject to 409A.)
- Various others.

5. Grandfathering.

Amounts both deferred and vested before January 1, 2005, can be grandfathered (exempt from Section 409A). If a grandfathered arrangement is materially modified, it will become subject to Section 409A.

6. Publicly-traded companies must designate "specified employees."

Generally, these are 5 percent owners, 1 percent owners with over \$150,000 in compensation, and officers with over \$150,000 of compensation for 2008 (amount is indexed). Benefits payable to specified employees on account of separation from service are subject to a mandatory six-month waiting period before they can be paid.

7. Timing of elections as to time or form of payment.

Generally, an employee's election as to the time or the form of payment must be made by December 31 of the year preceding the year in which services are performed that generate the compensation. In a severance plan subject to Section 409A, it is too late to make the election at the time of severance. Exceptions exist for "performance-based compensation," first year of eligibility, rights subject to substantial risk of forfeiture and some others.

8. Restrictions on distribution events under plan.

Generally, there are only six events that will support a distribution from a Section 409A plan:

- Separation from service.
- Fixed schedule by reference to objectively determinable dates, not events.
- Disability.
- Death.
- Change in control.
- Unforeseeable financial emergency.

"Acceleration" is permitted in certain situations at the discretion of the employer, not the employee. Examples: "early" tax liability, termination of plan under certain limited circumstances, domestic relations order and cash-out of small benefits.

9. Changing the time or form of a payment requires a long lead time.

Once a time or form of payment is specified, generally it can be changed only with at least 12 months advance notice and by postponing the payment date by at least five years.

10. Plans subject to Section 409A must be in writing and must include material terms.

The material terms include:

- Conditions under which a deferral election can be made.
- Amount of deferred compensation payable under the plan (can be a formula).
- Time of payment must be a Section 409A payment event.

- Form of payment.
- Conditions under which time or form of payment can be modified must comply with 12-month/five-year rule.
- Six-month delay for separation from service payments to "specified employees" of publicly-traded companies.

This article, authored by Lane Powell Shareholders Gail E. Mautner and Jeffrey W. Knapp, first appeared in Washington CEO magazine.

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