ASK A LAWYER

Tax change having immediate effect on rules for deferred compensation

Q. How does Internal Revenue Code Section 409A affect employment contracts and deferred-compensation arrangements?

On Oct. 22, 2004, President Bush signed into law the American Jobs Creation Act, which created Section 409A of the Internal Revenue Code. This brought about sweeping changes to the tax treatment of deferred compensation, an arrangement that provides for a portion of an employee's income to be paid out at a date after that income actually is earned. Examples of deferred compensation plans include bonus arrangements, severance payments and stock options.

The enactment of Section 409A was a visceral reaction by Congress to the actions of corporate executives at Enron who accelerated their own deferred-compensation benefits while leaving a majority of the employees with worthless securities in their 401(k) plans. While well-intentioned, Section 409A and the complexity of the 397 page regulations have left many companies struggling to understand and apply these new rules.

Section 409A generally prohibits deferred-compensation plans from accelerating distributions and restricts distributions earlier than certain trigger events. A violation of Section 409A results in the assessment of a 20 percent penalty tax and interest on the employee, in addition to immediate income inclusion to the employee or participant. The trigger events include separation from service, death, disability, a specified time, change in control or an unforeseeable emergency. Section 409A also provides for strict timing requirements for initial and subsequent deferral elections. Operational compliance with Section 409A has been required since the Jan. 1, 2005, effective date, and as a result of Notice 2007-78 released on Sept. 10, 2007, all deferred-compensation plan documents must be brought into compliance by Dec. 31, 2008.

Section 409A specifically exempts certain "qualified" deferred compensation. If an equity plan, severance-pay plan or employment-benefit arrangement does not meet the requirements of any exemption, it does not mean that the plan "fails" Section 409A and that the recipient is automatically taxed and penalized. However, it is important for employers to act now to identify those plans not compliant and to redesign them in accordance with Section 409A to avoid such a penalty. This identification and redesigning process may be easy or difficult, depending on the type of plan or employment contract involved, and likely will require employers to consult with legal and tax counsel.

Geoffrey Weinstein is an attorney in the tax, trusts and estates department at Cole, Schotz, Meisel, Forman & Leonard, P.A., the largest law firm in Bergen County. He can be reached at gweinstein@coleschotz.com.

Do you have a business question for a lawyer? Send it to BusinessNews@northjersey.com. This column is not intended to offer legal advice, which can be given only after the attorney understands the facts of a particular matter and the goals of a client.