



## Deferred Compensation – Greater Clarity And A Call To Action With Issuance Of Final Regulations

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Deferred compensation arrangements have recently been a hot topic of discussion and concern in light of the recent enactment of Section 409A of the Internal Revenue Code<sup>1</sup> as part of the American Jobs Creation Act of 2004.<sup>2</sup> Since the enactment of Section 409A, temporary and interim guidance has been issued for the operation of deferred compensation arrangements in good faith with such guidance. On April 10, 2007, final regulations were issued by the IRS and Treasury Department<sup>3</sup> interpreting the requirements set forth in Section 409A. As documentary compliance and operation is required by December 31, 2007, it is essential that all deferred compensation arrangements be reviewed and the appropriate amendments be made by the end of this year.<sup>4</sup>

Generally, Section 409A will apply to any arrangement wherein a service provider (i.e. employee, independent contractor, common law employee) receives a legally binding right to compensation in one year, but will not actually or constructively receive such income until a later year. As long as a payment **could** be made after the end of the taxable year in which the legally binding right is created, there is a deferral of compensation even though such compensation could also be paid in the same taxable year. A legally binding right to compensation may exist even though the right is subject to various conditions, such as substantial risks of forfeiture. A legally binding right to compensation does not exist if the service recipient (i.e. company) may reduce or eliminate the proposed compensation after the services have already been performed.

Deferred compensation arrangements include, but are not limited to, elective deferred compensation plans, severance and termination agreements, employment agreements, bonus and incentive plans, stock options, phantom stock arrangements, noncompete agreements and supplemental employee retirement programs.<sup>5</sup>

### A. Benefits Exempt from Section 409A.

Qualified retirement plans and Section 403(B) plans are not subject to Section 409A. Further, the regulations clarify that reimbursements are exempt from Section 409A for nontaxable amounts, deductible business expenses, outplacement and moving expenses, indemnification payments, medical expense reimbursements paid during the applicable COBRA period, settlements of bona fide legal claims for wrongful termination, employment discrimination, Fair Labor Standards Act, or workers compensation statutes (even if deemed to be taxable compensation for federal income tax purposes). The final regulations include an exemption for rights to educational benefits, provided the benefits are solely for the education of the service provider, and the benefits are solely for educational assistance. Also exempted from Section 409A are tax “gross-ups”.

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Reimbursement of nonexempt expense arrangements will be compliant with Section 409A if there is an objectively determinable, nondiscretionary definition of eligible expenses, a period for reimbursement is established, amounts available for reimbursement may not be carried over from one year to another, and all reimbursements must be made by the end of the year following the year in which the expense is incurred.

### **B. Short Term Deferrals.**

The final regulations create an important exemption for short term deferrals. No deferral of compensation exists if the payment is actually or constructively received by the service provider within 2½ months after the end of the year in which the service provider is entitled to receive such compensation. A delay of payment beyond the 2½ month deadline will not run afoul of Section 409A if the delay is based upon unforeseeable events or the payment would jeopardize the ability of the service recipient to continue as a going concern.

### **C. Specific Distribution Events.**

Under the final regulations, deferred compensation arrangements limit distribution to six designated events:

1. Upon separation from service by the service provider -- generally upon termination of employment for employees, and upon the expiration of the contract requiring the performance of services for independent contractors. For key employees of publicly traded companies, distributions must be delayed for at least six months after the key employee's separation from service.
2. Upon a fixed date or pursuant to a fixed schedule, in accordance with plan provisions. The schedule can be based upon a specified date, another permissible distribution event, or upon the lapse of a substantial risk of forfeiture.
3. Upon the service provider's disability, defined as the inability of a service provider to engage in any substantial gainful activity or the receipt of benefits for at least three months under an employer's disability plan as the result of medically determinable physical or mental impairment that is expected to result in death or continue for a period of at least 12 months.
4. Upon the service provider's death.
5. Upon a change in control or ownership of a service recipient or to the entity that is liable for payment of the compensation. A change of ownership occurs if a person or group of persons, acting together, acquires more than 50% of the stock of the corporation, measured by voting power or value. A change in effective control occurs if during a 12 month period, either a person or group acquires stock representing 30% of the voting power of the corporation or a majority of the members of the board of directors of the ultimate parent corporation is replaced by directors not endorsed by the persons who were members of the board before the new directors' appointment. A change in control based upon the sale of assets occurs if a person or group acquires 40% or more of the gross fair market value of the assets of a corporation during a 12 month period. This excludes transfer of assets to entities controlled directly or indirectly by the shareholders of a transferring corporation.

6. Upon the occurrence of defined unforeseeable emergencies. Unforeseen emergencies are based upon severe financial hardship arising from illness or accident of the service provider, spouse or dependents, a casualty loss incurred by the service provider, or other similar extraordinary unforeseeable circumstances arising as a result of events beyond the control of the service provider. In the event of an unforeseeable emergency, the amount distributable may not be more than is reasonably necessary to meet the demands of the unforeseeable emergency and any anticipated tax on the distribution.

Generally, once a distribution is triggered by any one of the events, the stated schedule of payments may not be modified, and no acceleration of payments is permitted. However, a plan may permit for alteration of payment upon more than one distribution event. For example, an employee may begin receiving payment of a series of 10 annual payments upon separation of service. If the employee subsequently dies before the final installment payment is made, the plan may permit a lump sum distribution of the remaining amount owed.

#### **D. Domestic Relations Orders.**

In the event of a divorce, a service provider may be subject to a domestic relations order requiring a distribution of deferred compensation. The final regulations permit plans to accelerate a payment to an individual other than the service provider to the extent necessary to comply with a domestic relations order, as defined in Code Section 414.

#### **E. Cost of Violation.**

There are significant tax implications for a violation of Section 409A that are imposed upon the service provider and all other service providers with similar deferred compensation arrangements. All affected service providers must include in income in the year of the violation all deferred income through such date, plus a 20% excise tax on that amount. Further, the additional tax associated with this income inclusion will be subject to interest at 1% above the current federal underpayment rate.

#### **F. Reporting Requirements.**

Section 409A requires the service recipients to report deferred compensation on Forms W-2 for employees and Forms 1099-MISC for directors and independent contractors. Employers will be required to withhold tax on the income arising from violations of Section 409A, treating such amounts as wages received in the year of violation. The withholding is only applied against the amounts included as income, and does not extend to the 20% excise tax or the additional interest. The Department of Treasury has indicated that more detailed guidance will be provided as to specific reporting and withholding requirements.

With the issuance of the final regulations, each and every business should be reviewing all compensation arrangements and plans, to determine if they are subject to Section 409A. It is expected that existing arrangements will require some modification to comply with the final regulations. As service recipients must maintain documentation for all elections, documents, forms, procedures and records should be reviewed and modified accordingly.

- 1 26 USC 409A.
- 2 Pub. L. No. 108-357, Sec. 885.
- 3 Treas. Reg. Secs. 1.409A-1 – 1.409A-6 (2007).
- 4 The IRS and Treasury Department have stated that no extension of this deadline is expected.
- 5 As the final regulations (including the preamble) were just under 400 pages in length, a complete analysis would exceed the style and page limitations of this publication. Accordingly, key issues are identified. This article is not intended to address all plans, arrangements, issues, and considerations.