Are Your Executive Compensation Agreements Up to Date?

IRS Introduces Section 409A Correction Program

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Very few compliance violations impose tax penalties as severe as those that apply under Section 409A of the Internal Revenue Code ("Section 409A") to individuals who are covered under nonqualified deferred compensation agreements. If executives and others in your organization are covered under a top-hat plan, a supplemental retirement plan, an employment agreement or another form of nonqualified deferred compensation agreement,[1] there is a limited opportunity to amend those agreements to avoid accelerated federal income tax liability, premium interest on late tax payments and a 20 percent penalty. The most favorable treatment applies to agreements that are corrected by December 31, 2010.

Because the rules are so complex and extensive, a nonqualified deferred compensation agreement that has not been revised specifically to address Section 409A is highly likely to be out of compliance with the Section 409A requirements. Sanctions will apply to the individuals covered by the agreement even if they have not received a distribution. Many small and mid-sized employers have not addressed the need to comply with Section 409A despite the fact that harsh penalties will affect their top executives. Some agreements have been amended to meet the 409A requirements, but may not have been drafted as precisely as necessary. In an effort to bring all agreements into compliance, the Internal Revenue Service has a program that allows affected agreements to be amended with dramatically reduced penalties (and in many cases, no penalties) if action is taken by December 31, 2010. The program is set forth in Notice 2010-6 (the "Notice").

What are the Section 409A Requirements and Penalties?

Section 409A applies to compensation to which an individual (typically, an employee) has a legally binding right in one year but does not actually or

1 Top-hat plans are plans that cover a select group of highly compensated employees. Supplemental retirement plans provide benefits to certain highly compensated employees in amounts in excess of the contribution and benefit limits for qualified retirement plans (hence, they supplement the qualified plan). Other forms of nonqualified deferred compensation agreements include incentive plans and other types of arrangements where income that is earned and vested in one year is paid in a later year.

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constructively receive until another year. Section 409A imposes restrictions on the timing of making an election to defer compensation. For example, the election must be made before the services are performed and must set forth the time and form of payment (for example, lump sum payment or installments). Section 409A also severely limits the events when deferred compensation can be paid. These times and events are limited to disability, death, separation from service, change of control, unforeseeable emergency and payments made pursuant to a fixed schedule. Additional deferrals of the time of payment are limited, as are changes to the form of payment. Acceleration of the payment of compensation is virtually prohibited. Furthermore, payments to a key employee of a public company upon separation from service must be delayed for a minimum of six months after the separation from service.

A failure to comply with Section 409A operationally or in the form of the agreement results in immediate taxation of vested amounts to the employee for current and prior years. In addition, a 20 percent penalty applies to the amounts includible in income, and premium interest rates are assessed. The employer is required to report income includible under Section 409A on Form W-2 for employees and Form 1099-MISC for independent contractors.

What Problems Can be Corrected?

The Notice lists specific document failures that can be corrected with no penalties or reduced penalties. The principal types of document failures are described here.

Impermissible payment event. Many agreements permit a distribution upon "retirement" or when an employee "ceases active full-time employment." These are not permissible payment events under Section 409A, and can result in a faulty document and a 409A violation. Terms such as these can be changed to a definition of "separation from service" that complies with Section 409A. Care should be taken to follow the specific parameters for part-time employment that are intended to ensure that the agreement pays benefits precisely and only when due. Other faulty payment events are noncompliant definitions of disability and change in control, which can be corrected under the Notice.

Impermissible time period following the payment event. Section 409A focuses on the timing of distributions so that the employee cannot influence the tax year in which income will be paid. There are specific time corridors after the payment event that comply with Section 409A. The employer and the employee cannot have discretion in the timing of the payments. Many severance agreements commence payment after the employee returns a release, which gives the employee the discretion to postpone the payment of severance, which creates a 409A violation. The IRS provides an example of language that can be used for a release of claims in compliance with Section 409A. The example provides for payment on the 90th day following separation from service provided that the employee has executed and submitted a release of claims and the statutory period during which the employee is entitled to revoke the release of claims has expired on or before that 90th day. Unless your severance agreements have this type of language, the correction program should be used to revise the agreements.

Other failures. The Notice allows certain impermissible payment events to be changed to permissible payment events. The Notice allows ambiguous terms under the agreement to be clarified. The Notice allows an employer to correct impermissible deferral elections. The Notice also allows agreements to come into compliance with the requirement that only a single form of payment is permitted for any payment event. The Notice allows agreements to add the six-month delay for specified employees of publicly traded companies.

Conditions for Relief under the Notice

Only employers and employees who are not under audit are eligible for relief under the Notice, and the Notice does not cover agreements in connection with certain tax-abusive transactions. The document failure must be inadvertent and unintentional. Employers must take commercially reasonable steps to locate agreements with similar document failures and correct those agreements as well. Furthermore, both the employer and the employee must attach a statement to their respective federal income tax returns that discloses the correction. Any applicable taxes must be paid.

For some corrections, absolutely no taxes or penalties are due although the statement still must be attached to each party's tax return. For other corrections, a portion of the tax (25 percent or 50 percent) is due. Under certain circumstances, some tax is due only if an event (such as separation from service) occurs within a year of the completion of the correction. The correction is not considered complete until the agreement has been amended and adopted and has become effective. In many cases, no taxes and penalties are due if the correction is completed by December 31, 2010. Special relief also is available for corrections by new nonqualified deferred compensation agreements with faulty documents.

Conclusion

Some of the harshest penalties under the Internal Revenue Code apply to individuals who are covered under nonqualified deferred compensation agreements – typically, the top executives of the enterprise. Because the rules are complex and highly specific, many agreements fail to comply with Section 409A operationally. Also, many agreements fail to set forth the complete, precise and accurate provisions as required under Section 409A. The IRS has provided an opportunity to avoid all or much of the penalties under a broad range of circumstances. Although the Notice allows corrections to agreements in future years, the most favorable results apply to corrections made by December 31, 2010. Because board action may be required to approve the amended agreements, the time to act is now.