Companies Should Monitor Deferred Compensation Arrangements For Section 409A Compliance Purposes

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03.10.2015

Given the complexity of the rules under Section 409A of the Internal Revenue Code, which govern the timing and taxation of payments made under non-qualified deferred compensation arrangements (NDCAs), companies are encouraged to monitor the arrangement's compliance with Section 409A. The application of Section 409A has been broadly interpreted and impacts almost every type of NDCA, including employment agreements, severance agreements, equity plans, stock option plans, and incentive bonus plans. Additionally, the IRS has recently begun a pilot program to review NDCAs for Section 409A compliance. Although this pilot program is only targeting highly compensated executives of large companies at this time, practitioners believe that the IRS will widen the scope of the pilot program over the next few years. Generally, Section 409A regulates NDCAs in four main areas. First, Section 409A restricts the timing of distributions to certain events or specific dates. Permissible distribution events include the employee's death, disability, separation from service, or a change in control of the company. Second, Section 409A imposes restrictions on the employee's right to accelerate or postpone the payment. Third, Section 409A requires that the form and schedule of such payments (e.g., installments or lump sum) must be fixed at the time the compensation is deferred. Finally, deferral elections must be made before the affected deferred compensation is earned. If a NDCA fails to comply with Section 409A, in either form or operation, then the compensation deferred under the NDCA will be subject to current taxation and an additional excise tax of 20% will be imposed on the deferred amount.

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Practice Areas

Employee Benefits and Executive Compensation

Executive and Non-Qualified Deferred Compensation Benefits

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Although the additional tax is imposed on the employee and not the company operating the plan, companies operating NDCA are encouraged to comply with Section 409A. Because the employees participating in such arrangements are usually key executives, violating Section 409A may lead to a disruption in company performance as well as potential IRS review and even employee lawsuits.