PUBLICATION

Code §409A and Hidden Deferred Compensation

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By now, you are probably aware that all deferred compensation arrangements must be written to comply with §409A. New IRS Notice 2007-86, issued on October 22, generally extends the documentary compliance deadline to the end of 2008. Good faith compliance in the interim is still required. But you might be surprised at the many various arrangements that are considered deferred compensation arrangements requiring compliance with §409A.

Under the final regulations issued by the IRS earlier this spring, contracts and agreements that you may have assumed were exempt from the strict rules governing deferred compensation are now covered. Section 409A doesn't just apply to traditional deferred compensation arrangements where an executive defers this year's bonus for payment at retirement. This relatively new law (§409A was enacted as part of the American Jobs Creation Act of 2004) contains a broad definition of "deferred compensation" that encompasses any compensation for services performed now but which is paid in a subsequent year. With this broad definition, much otherwise "hidden" deferred compensation is potentially subject to the new rules. You may want to consult your document file drawers for any of the following:

- Employment contracts;
- Change of control agreements;
- Severance plans or policies;
- Discounted stock options;
- Option agreements where there is discretion to change the exercise price after award or where the grant price is less than fair market value of the stock on the date of grant;
- Deferred stock unit plans;
- Restricted stock arrangements;and
- Any nonqualified deferred compensation arrangement, such as a SERP, Top Hat Plan or directors' plan.

The penalties to the executive are severe if the documents are not compliant. Generally, an executive who participates in a deferred compensation arrangement that is subject to §409A is immediately taxed on the value of the deferred compensation, plus the executive will have to pay a 20% excise tax on the amount that is included in income, as well as a penalty. Withholding by the employer is required on the early income inclusion but not on the excise tax or penalty. Discounted stock options that are subject to §409A may, under certain circumstances, be cured by a timely written amendment. Finally, if the executive participates in more than one deferred compensation arrangement, the failure of one arrangement could also cause the other arrangement(s) to fail to comply with §409A.

In addition to documentary compliance issues, §409A also impacts merger and acquisition transactions. The §409A rules will increase the cost of acquiring a company, whether public or private, if careful due diligence is not performed prior to signing the acquisition agreements.

The potential hidden costs to a buyer include liability for the target company's failure to satisfy its tax withholding obligations with respect to deferred amounts, possible breach of contract claims for amendments or terminations of benefits where a required consent of the employee was not obtained, and gross-up payments to executives of the target company as a result of the imposition of excise taxes under §409A. For any transactions involving deferred compensation, it will be important to work closely with your employee benefits lawyers to identify the risks of noncompliance with §409A and to reflect those risks properly in the transactional documents.