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Good Company

New Deferred Compensation Rules: Another Potential Headache for Small Business Owners

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In many closely-held businesses, deferred compensation is often a part of a business owner's retirement planning. In the context of a multi-shareholder corporation, sometimes a retiring owner will have an agreement with his fellow shareholders that when he retires, he will be paid a certain amount of deferred compensation in addition to receiving payment for his stock. This deferred compensation is deductible to the corporation and is taxed as ordinary income to the recipient.

One of the many public policy initiatives that arose out of the corporate scandals of Enron and Worldcom was the enactment by Congress in 2004 of Section 409A of the Internal Revenue Code ("IRC"). Section 409A was a response to the excessive executive pay packages that allowed the senior management of such companies to retire in comfort while the rank and file saw their pension assets disappear.

Unfortunately, in its zeal to tighten the rules applicable to high-powered CEOs, Congress cast a wide net. Many small business owners, including professionals such as physicians lawyers and accountants, will find that they, too, have become ensnared in the 409A net. Section 409A contains an exceedingly broad definition of "deferred compensation" which includes most small companies' deferred compensation programs.[1] The new IRC provisions severely restrict the flexibility previously afforded these programs.

"Nonqualified deferred compensation" includes "any arrangement that provides for the deferral of compensation," other than certain arrangements expressly excluded from the definition. A plan provides for the deferral of compensation if, "under the terms of the plan and the relevant circumstances, the [employee] has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to the [employee] in a later year." Many small business owners and key, non-owner employees have an agreement, sometimes a stand-alone document, sometimes contained in their employment contracts that provides for the payment of deferred compensation to the recipient in the event of death, disability, retirement or termination of employment. Deferred compensation is often paid over several years, providing the departed owner or key employee with supplemental income and allowing the company sufficient time to pay it out in a manner that does not have a devastating effect on cash flow. Such an arrangement may now be subject to the new 409A rules.

Unless a covered deferred compensation plan meets all of the

requirements of 409A, the recipient of the deferred compensation must include the compensation in income upon the later of: (1) the time the compensation is deferred, or (2) when the compensation is no longer subject to a substantial risk of forfeiture (e.g., when vested). In addition, an employee could be subject to interest and a penalty tax equal to 20% of the compensation.

Many of the 409A rules will require amendments to common deferred compensation plan provisions. For example, the election to defer compensation must be made prior to the calendar year in which the services will be performed. In most cases, business owners enter into these deferred compensation agreements at the time they become shareholders in their corporation and key employees execute written employment agreements containing deferred compensation provisions. These procedures should satisfy the 409A requirement that "newly eligible [service providers] will have 30 days after they become eligible to elect to defer future compensation earned after the election is made." If the election to defer compensation is made at a later date, it should be properly documented.

Many deferred compensation plans for closely-held companies also permit the company to accelerate the payment of the deferred compensation. Section 409A does not permit such acceleration. Deferred compensation agreements that were entered into prior to January 1, 2005 are not subject to IRC 409A and can retain this provision. New deferred compensation agreements entered into after January 1, 2005 cannot contain such a prepayment option.

Amounts required to be included in income under 409A are subject to income tax withholding and reporting rules. However, the IRS has suspended these rules for deferrals of compensation subject to Section 409A arising in calendar year 2005. Amounts that are deferred but that are not currently subject to income tax must nevertheless by reported on Form W-2 (or 1099 in the case of an independent contractor) in the year deferred and are subject to employment tax withholding if the recipient is an employee. However, amounts that are not "reasonably ascertainable" are not required to be reported until such deferrals become reasonably ascertainable. Because most small companies' deferred compensation agreements use a formula to arrive at the amount of the deferred compensation to be determined upon the occurrence of a specified event (such as death, disability or retirement), and because many such formulas are based on some percentage of salary or other benchmark on the date of the triggering event, the reporting requirement will attach only when the amount of the deferred compensation can be determined, i.e., after the triggering event occurs.

The rules implementing Section 409A are complicated and we have only pointed out a few of the more commonly applicable issues in this article. Companies with arrangements that might fall within the ambit of 409A are advised to seek advice of their attorneys or tax advisors to bring such arrangements into compliance. Failure to do so could have significant consequences on departing employees and their employers.

For more information on Section 409A, please contact Matt Lapointe 603.627.8172; Peter Beach at 603.627.8185 or Peter Leberman at 603.223.2020.

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[1]Specifically excluded from the definition are certain qualified retirement plans, vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.