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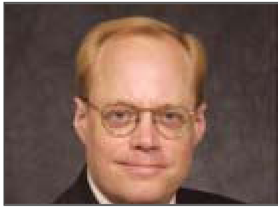

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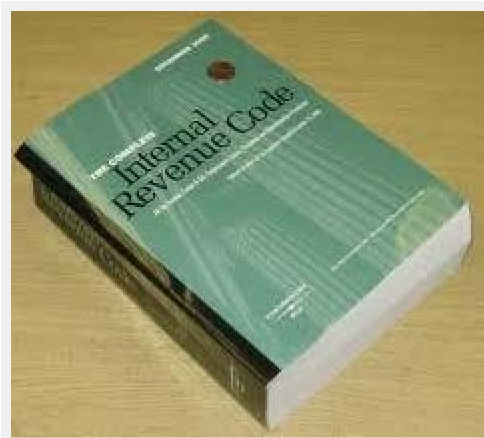
Got Deferred Compensation? Beware Section 409A



Saying “pay me later” can be tempting so taxes are due later. You can often navigate the tax concept of constructive receipt so you are taxed later. But in 2004, Congress restricted deferring income into the future with new section 409A of the tax code.

At its root, section 409A provides that some compensation you defer is nevertheless currently taxed. Amounts deferred under a nonqualified deferred compensation plan are currently taxed if not subject to a “substantial risk of forfeiture.” A nonqualified deferred compensation plan includes virtually any agreement, method, program or other arrangement that provides for deferral, where the compensation is not paid until a later year.

The following are among the many types of plans covered: Employment, bonus or compensation agreements where money is paid later; Supplemental executive retirement plans (sometimes called SERPs); and other nonqualified retirement arrangements; Restricted stock, phantom stock and performance share plans; stock appreciation rights; and long-term or multi-year bonus or commission programs.

In fact, virtually any kind of deferred compensation arrangement is covered. Change in control agreements, severance agreements, employment agreements, agreements covering the delayed payout of option proceeds, etc., are all fair game.

Different considerations apply to public companies and private companies. Section 409A has even longer teeth when it comes to publicly held entities. As one example, there is a six-month delay in the case of distributions to key employees from publicly held corporations.

In general, stock options are treated as nonqualified deferred compensation under section 409A if the stock options have an exercise price that is less than the fair market value of the underlying stock on the date of the grant. Thus, these options are "in the money" when they are granted. Part of most business purchases involves the acceleration of vesting and cashing out options on closing. In many cases, section 409A may subject the option holder to extra taxes.

Severance and Employment Agreements. Severance agreements, employment agreements and consulting agreements are prime places to encounter section 409A. They often offer replacement consideration for deferred compensation benefits that will not be available.

This is important, since payment of benefits that act as a substitute or replacement for deferred compensation under a plan can also be subject to section 409A. The right to the new payment can be considered an impermissible acceleration of the forfeited deferred compensation.

This abbreviated discussion barely scratches the surface of section 409A. There are exceptions, but the reach of section 409A is quite broad and it's impact negative. It can crop up wherever payments are delayed or contingent. Be careful.

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009 with 2012 Supplement, Tax Institute), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.