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When Good Deferred Compensation Plans Go Bad

By Joel Rothenberg, CPA

Most deferred compensation plans are created with good intent. They can go bad, however, if improperly executed. Like when Enron executives accelerated their deferred compensation payments so they could access the money before the company went bankrupt.

They can also be bad for business if they don't comply with IRC Section 409A, which was enacted as a result of the Enron scandal. If your company has a nonqualified deferred compensation plan, you must be in compliance by **December 31, 2008**. To avoid significant tax and penalties for non-compliance, you need to be informed.

What is deferred compensation?

Generally, deferred compensation is a present, legally enforceable right to taxable compensation for current services that will be paid in a later year.

What are examples of a deferred compensation plan?

- Elective deferred compensation agreements
- Buy/sell agreements
- Shareholder agreements
- Nonqualified stock options issued at a discount
- Split dollar life insurance
- Employment agreements/severance arrangements
- LLC agreements that address member death, disability or retirement
- Other agreements that defer current rights to compensation to a future period

Who suffers the consequences for the violation?

While Section 409A applies to the employer, it is the employee/independent contractor/director who bears the consequences.

What are penalties for violating these provisions?

- A violation under these rules will result in the immediate recognition of all income deferred under the "409A" plan, **PLUS**
- 20% penalty, **PLUS**
- Interest

Note: the accelerated tax, penalty and interest accrues to the individual taxpayer, even though the responsibility for plan compliance rests with the company/sponsor of the plan.

Don't let your deferred compensation plan "go bad" and incur significant tax and penalties for non-compliance. Contact Dave Sullivan, Stephen Minson or Joel Rothenberg if you have any questions or need our assistance in meeting these new rules.