Morgan Lewis

deskbook

Emerging Life Sciences Companies

second edition

Chapter 12

Section 409A of the Internal Revenue Code

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The American Jobs Creation Act, signed into law on October 22, 2004, added a new section 409A to the Internal Revenue Code of 1986, as amended (the Code). Section 409A makes numerous changes to the taxation of deferred compensation. In general, the changes made by section 409A fall into four categories: the timing of deferral elections, the timing of distribution elections, the events upon which a distribution may be made, and future changes to distribution elections.

The effect of section 409A is to impose significant restrictions on the structure and operation of deferred compensation plans, and to extend the scope of the deferred compensation tax rules to areas not traditionally thought of as deferred compensation (e.g., severance, discounted stock options and stock appreciation rights and bonus plans). Section 409A affects traditional nonqualified deferred compensation plans, supplemental executive retirement plans, change-of-control agreements, employment agreements and severance plans and agreements, as well as bonus and long-term incentive plans.

In general, section 409A applies to compensation deferred after December 31, 2004, except in limited circumstances where previously deferred amounts may be grandfathered. Under section 409A, deferred compensation is taxed as of the date the income is fully earned and not subject to substantial risk of forfeiture. Failure to comply with section 409A results in current taxation of deferred amounts and the imposition of a 20% additional tax, as well as possible application of a penalty interest rate to the tax underpayment. Thus, it is critically important for employers to examine their deferred compensation plans and severance payments to determine whether they are in compliance with the requirements of section 409A.