Update: Deferred Compensation Compliance

In 2005, Congress dramatically changed the landscape of deferred compensation arrangements. In the wake of this new legislation, the IRS and Treasury Department issued volumes of regulations mandating how such arrangements must be structured. These regulations were scheduled to go into effect on January 1, 2007. However, on September 10, 2007, good news was announced – we now have one more full year to get deferred compensation documents into compliance. This does not mean that we are off the hook completely. The January 1, 2008 deadline for operational compliance is quickly approaching.

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Q: What should be my company's first step?

A. Your company may have more plans than you think. The first step is to identify all payment arrangements that might be impacted. The legislation is VERY broad and encompasses all arrangements that provide for deferred compensation with only a few exceptions. "Deferred compensation" is any compensation which is earned in one year and is or may be payable in a following year.

Common examples of affected arrangements include salary and bonus deferrals, supplemental executive retirement plans (SERPs), stock appreciation rights and phantom stock, discounted stock options, certain severance agreements, restricted stock units, and mirror plans.

Q: My company has deferred compensation plans. What should be done to comply?

A: The overarching theme of the new regulations is to limit the ability of an individual or company to manipulate the inclusion of income or the method of payment in order to reduce income taxes. To incorporate this theme, there are four general issues over the course of a deferral the IRS has targeted: (1) the initial deferral election, (2) the timing of payments, (3) acceleration of payments, and (4) subsequent deferral elections.

There are rules for each of these issues that reduce the employee's or company's ability to alter or change the form of payment and timing of the deferral. For instance, at the time of the initial deferral election, the form and time of payment must be specified. Later, if the employee decides to make a subsequent deferral to delay payment beyond the date as provided in the initial election, payment cannot be made until at least five years beyond the initially scheduled payment date in most cases.

Q: What are the consequences of noncompliance?

A: Compliance is critical. Failure to comply, in any respect, may render deferred compensation immediately taxable and cause an additional 20% penalty to be assessed. To further compound the tax costs, the IRS will impose late payment interest on the taxes owed. This late payment interest may begin to accrue from the date of the original deferral.

While these rather harsh tax sanctions fall on the employee, their impact may be felt by the employer, either through a formal indemnification agreement if the employer fails to amend the plan document to comply with the new rules or through employee dissatisfaction.