Action Required Now on Employment, Severance and Deferred Compensation Arrangements

Joel C. Farrar

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In 2004 Congress enacted Internal Revenue Code ("Code") Section 409A, which dramatically changes the requirements for maintaining nonqualified deferred compensation arrangements. The new law expands the definition of a "deferred compensation arrangement" and imposes significant penalties on service providers (including employees and independent contractors) who participate in deferred compensation arrangements unless the arrangement is amended by December 31, 2008 to comply with the new rules.

Any arrangement that results in a person receiving compensation in a year following the year in which the compensation is earned is potentially subject to the rules and penalties of Code Section 409A. These arrangements now include employment agreements, bonus arrangements, severance plans, stock incentive plans, and management service contracts, even though these arrangements were not always treated as deferred compensation under prior law.

Deferred compensation arrangements must comply with Code Section 409A before January 1, 2009. Otherwise, the service providers who benefit from the arrangements will be required to recognize all amounts "deferred" under the arrangements as income, plus interest and a 20% penalty. The service recipient (usually the employer) could also be subject to penalties and interest for not withholding sufficient income, FICA and FUTA taxes. Accordingly, all arrangements potentially providing for the deferral of compensation must be reviewed and, if necessary, amended prior to January 1, 2009.

CONTACT

Joel C. Farrar
P: 517.371.8305
E: jfarrar@fosterswift.com

AUTHORS/ CONTRIBUTORS

Joel C. Farrar

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