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EXECUTIVES, WORKERS SHOULD BE AWARE OF 409A TAX HIT

By Matt Henshon

A few months ago, I wrote about the challenges facing startups because of new section 409A of the Internal Revenue Code ("Startups need to budget for 409A costs," Feb. 27). But executives and employees must also be concerned about 409A, especially this year. (Although "employees" refers to both employees and executives, the same rules apply to independent contractors.)

Section 409A states that compensation promised, but not paid (i.e. deferred), to employees is either subject to "substantial risk of forfeiture" or else is eligible for immediate taxation.

Timing is important to understanding 409A. The law became effective Jan. 1, 2005. In late September 2005, the IRS proposed regulations initially intended to be retroactive to the beginning of 2005. Then, last December, the IRS essentially suspended reporting regulations for employers for 2005.

But while employers were relieved from their reporting obligations last year, employees were nonetheless supposed to report the section 409A income; as a practical matter, without corresponding reporting by employers on W-2s or 1099s, most taxpayers were probably not aware of their obligation.

With the proposed regulations published last fall, and with the likelihood of the regulations being finalized before the end of the year, many observers believe that 409A will be in effect for 2006. Yet some employers and employees seem to be acting as though the 409A regs do not, or will not, apply to 2006 actions. While employers will be able to fulfill their 409A obligations, if any, simply by delivering a tax form (either W-2 or 1099) next spring, employees who do not plan for the coming liability may get a rude surprise next spring.

While 409A is broad, at least three areas should be a concern to employees: deferred bonuses, severance payments and stock options. Bonuses should be paid within the year the amount is earned, or within 2 1⁄2 months after the end of that calendar year. Large severance payments (more than twice the annual salary, or more than about $400,000 total) are also problematic. Severance payments should be completed by Dec. 31 of the second year following the year of termination. In addition, under section 409A, a noncompete agreement is not adequate consideration to extend a severance penalty.

Finally, anyone who received nonqualified stock options -- employees, distributors or independent contractors -- should be sure the company has determined fair market value of the options in accordance with the section 409A "safe harbor" procedures.

Why the concern? If 409A rules are not followed, the penalties can be severe: The IRS can charge interest (currently 8 percent) on the unpaid amount, plus an additional 20 percent penalty of the amount under-reported. And remember the employee probably does not have the cash (the income is often all deferred).

In short, executives, employees and independent contractors should be on guard when they accept deferred bonuses, negotiate severance payments, or otherwise enter into new option contracts, especially during the current transitional period through the end of 2006. While section 409A requires reporting compliance by companies, the tax burden falls on the employees.

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