OVERVIEW OF § 409A:

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Applies to:

Any arrangement to pay a service provider in the future, except:
- Qualified retirement plans (including certain IRC § 457 plans)
- Vacation, sick leave, compensatory time, disability pay or death benefit plans

It essentially applies to most any legally binding obligation to pay compensation in the future.

Amounts deferred in tax years beginning prior to 2005 are exempt, unless the plans under which they were deferred are materially modified after October 3, 2004.

Also exempt from § 409A are most arrangements with independent contractors, and short-term deferrals (paid within 2 ½ months of end of the year).

Key to § 409A: Don't violate one of these three rules:
- Distributions
- Acceleration of benefits
- Elections

The Plan must contain language that meets these requirements and must be operated in compliance with them.

Distributions:

Once compensation is deferred under a plan, it cannot be paid earlier than:

1. Time of separation from service
   (6 Months after separation for certain key employees of publicly traded companies)
2. Disability
3. Death
4. A specified time (or via a fixed schedule) as set forth in the Plan at the time income is deferred
5. A change in ownership, or control, of the corporation
6. Occurrence of an unforeseen emergency

Acceleration of Benefits:

Except as provided in Regulations, the Plan cannot permit the acceleration of any payment.

Elections:

Must meet two requirements:
1. Initial deferral decision
2. Changes in time and form of distribution

Initial deferral decision:

- The election to defer generally must be made in the year prior to the year in which the services giving rise to the deferral are performed

- In first year of eligibility to participate in the Plan, the election can be made within the 30-day period after becoming eligible. The election to defer compensation will only apply to services performed after the election is made.

- For performance based compensation:
  If the period over which the services are performed is at least one year, then the election can be made up to six months before the end of the period

Changes in time and form or distribution:

- If the Plan permits a subsequent election to delay payments the election must be made at least 12 months in advance.

- In the case of a payment to be made:
  - as a result of separation from service
  - at a specified time (or via a fixed schedule), or
  - due to a change in ownership

  then deferral must be for at least 5 years from the original payment date.

- In the case of a payment to be made at a specified time (or via a fixed schedule), the election must be made at least 12 months before the first scheduled payment.

Consequence of failing the 3 primary rules:

1. All compensation deferred under the plan (to the extent not subject to a substantial risk of forfeiture) becomes taxable.

2. Additional costs imposed:
    - 20% penalty, and
    - interest on tax that would have been due, if the compensation had been paid in the year earned, instead of having been deferred

This only applies to the specific person to whom the failure applies, not necessarily to all participants in the Plan.

Rules related to Funding:

If, in connection with deferred compensation plans, employer assets are set aside in certain ways to fund the deferred compensation obligations then such assets will be treated as "property transferred in connection with the performance of services" and pursuant to IRC § 83 will be currently taxable to the employee. In addition, the employee will be subject to the 20% penalty and interest on the deferred tax liabilities dating back to the original deferral.

These prohibited transfers include:

- Transferring funds to trusts or other arrangements for the purpose of paying the deferred compensation of certain key employees of public companies;

- Restricting such funds to the provision of benefits under the Plan (even if the funds are subject to creditors) in connection with a change in the employer's financial health;

- Transferring funds to locations outside the United States

In addition, if the employer pays an employee's income taxes due to the above rules:

- The amounts paid for the employees' taxes become subject to the 20% penalty and interest; and;

- The employer cannot deduct such payment