

## New IRS Regulations To Have Major Impact on Incentive Programs

[James A. Houle, Esq.](#) | July 24, 2007

New IRS regulations will have a significant impact on standard incentive programs offered by employers such as deferred compensation, employee stock options, stock appreciation rights, restricted stock plans, severance benefits, split-dollar life insurance, so-called rabbi trusts, and supplemental executive retirement plans (i.e., SERPs).

The new regulations apply to all employers—including corporations, partnerships, LLCs, and non-profits—and to all individuals who receive money for services, whether as an employee, member of the board of directors, outside advisor, or independent contractor.

This new law came about because Congress concluded that Enron had manipulated tax laws in setting up its executive incentive compensation and deferred compensation plans. In response, Congress enacted strict new laws under Section 409A of the Internal Revenue Code, and the IRS has now issued detailed regulations to the new law.

**The regulations apply to most incentive and deferred compensation arrangements that will pay benefits after December 31, 2004. Existing incentive and deferred compensation arrangements must be amended by December 31, 2007, to comply with the regulations. Failure to timely amend an arrangement generally results in the severe tax consequences mentioned below.**

Violating the new regulations will result in significant taxes and other costs:

- First, the full amount of the deferred compensation or other benefit payable to the employee will be taxed to him or her in the year the violation occurs, even if the amount is not paid until years later, such as at retirement.
- Second, the employee will be subject to a 20 percent tax penalty. For example, if a deferred compensation plan will pay a company's CEO \$1 million on his retirement and the plan fails to comply with the new regulations before January 1, 2008, then the CEO will be taxed on the \$1 million in 2008, even though he will not receive the \$1 million until he retires. In addition, the CEO will have to pay a 20 percent penalty on the \$1 million.
- Lastly, if the CEO fails to timely report the \$1 million of "deemed" 2008 income, he will pay interest when the IRS finally assesses taxes, and the interest rate will be higher (by 1 percent) than the normal IRS rate for late taxes.

**The employer will also encounter tax problems.** In the above example, the employer would be obligated to withhold state and federal income taxes on the \$1 million of “deemed” 2008 income. If there is no withholding, the employer could be subject to additional federal and state penalties.

The regulations severely restrict how incentive programs are funded, how benefits can be deferred, and when benefits must be paid out to the employees or other recipients. They apply not only to plans that cover several employees, but also to individual agreements with employees. For example, if an employer has an employment agreement with its chief executive officer that contains a deferred compensation payment to be made in a future year, the deferred compensation is very likely subject to the new regulations and will have to be amended before 2008 to avoid tax problems.

*We would be pleased to assist you in reviewing and amending your compensation arrangements to comply with the new regulations. To request a review or to get more information, please call your Bernstein Shur attorney or contact:*

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*Since all plans subject to the new regulations must be reviewed and modified before the end of 2007, your early response will assure that we have sufficient time to make needed modifications.*