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Section 409A Compliance Again?

Presented by Integrated Healthcare Strategies
as authored by Marilyn Kern, Senior Consultant

By now, Internal Revenue Code Section 409A's impact on deferred compensation should be old news. After all, it's been around since 2004 and has been the focus in numerous healthcare industry articles and webinars. However, in the course of performing executive total compensation reviews for new not-for-profit healthcare clients, we are surprised to still regularly receive documents that have not been updated to comply with 409A regulations.¹

409A warrants special attention because its rules must be considered when designing and drafting employment, deferred compensation, and severance arrangements. Organizations must operate plans in "good faith" compliance with 409A requirements, regardless of whether their plan documents have been amended to comply. But, more importantly, noncompliance can subject the employee to huge penalties. For example, in addition to a 20% penalty tax on the non-compliant payment, noncompliance in one situation often subjects other payments received by that employee to the 20% penalty tax.

Remember, 409A applies to many types of plans: nonqualified deferred compensation plans (e.g., SERPs and Section 457(f) plans), employment agreements, severance arrangements, bonus/incentive plans, post-retirement benefits, change in control agreements, split-dollar life insurance arrangements, and the like.

In an effort to identify whether certain plan types were the main noncompliance culprits, we asked recent survey participants the five 409A compliance questions below.

1. Have your deferred compensation documents been reviewed and updated to comply with Internal Revenue Code 409A regulations?
2. Have your executive employment agreements been reviewed and updated to comply with IRC 409A regulations?
3. Has the separation pay plan exemption (from IRC 409A regulations) been added for severance arrangements defined in your employment agreements?

¹ Total compensation reviews include analysis of base salaries, incentives, benefits, perquisites and total compensation.

4. Do your employment agreements allow executives to choose whether to take severance benefits in a lump sum or have it paid out over time?
5. Do your incentive plan payout practices comply with 409A regulations?

The results are interesting. Between 40% and 45% of respondents reported that their deferred compensation, employment agreements, and incentive plan documents had been updated. The remaining respondents either haven't updated, don't know if they've updated, or don't know what changes to make. Fortunately, about half have added the separation pay plan exemption to their employment agreements, which bodes well for those executives who can take advantage of this exemption. Less fortunate, though, is that over 40% of respondents still allow executives to choose how their severance benefit will be paid out, which is problematic.

In 2010, the IRS adopted 409A Document Failure Correction Procedures (IRS Notice 2010-6) to help organizations correct noncompliant documentation. Though technical and complex, the procedures offer some relief in many instances. We recommend that organizations pursue this avenue with a trusted advisor and legal counsel who are well-versed in 409A regulations.

With severe penalties for noncompliance, unfortunately, what you don't know can hurt you. If you answered "no" or "don't know" to any of the above questions, it may be wise to obtain further information about 409A compliance. Please contact us if you would like a document review.

About the Author

Marilyn Kern is a Senior Consultant with the Executive Compensation and Governance practice of Integrated Healthcare Strategies. Ms. Kern may be contacted at marilyn.kern@ihstrategies.com or at 612-339-0919.

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Integrated Healthcare Strategies provides healthcare organizations with direct access to a comprehensive array of healthcare-specific services, delivered by professionals from the industry who understand the rigors of running a healthcare organization – from the lunchroom to the Board Room. Its client list is a "who's who" of healthcare organizations including over 1,200 major healthcare providers, 1,800 hospitals and 700 independent and affiliated medical groups.

Integrated Healthcare Strategies specializes in the areas of executive compensation, physician strategy and compensation, employee compensation, human capital solutions, labor relations, leadership transition planning, executive search, employee surveys, performance management, and board governance solutions.

The Executive Compensation and Governance practice of IHStrategies provides valuable information, design, and strategy for a variety of governance and leadership issues and challenges. These services include executive, director, and middle-management compensation program review and design, leadership continuity planning and development, governance model design development, board retreats to enhance effectiveness, CEO and executive performance development and appraisals, physician leadership development and alignment services, and many other governance and compensation services.

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