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Final Section 409A Deferred Compensation Regulations Become Effective–All Plans Must Comply by December 31, 2008

The IRS issued final regulations under Internal Revenue Code section 409A on April 10, 2007. To avoid significant penalties, applicable nonqualified deferred compensation arrangements must be in compliance with the final regulations by December 31, 2008 (unless the plan is eligible for an exception).

Background

Code section 409A was in enacted in 2004 to prevent perceived abuses associated with "nonqualified deferred compensation." The law sets forth detailed election, distribution and acceleration rules (among others) for nonqualified deferred compensation. Code section 409A's penalties are severe. Upon a plan failure (operational or documentary), all amounts deferred become taxable. In addition to regular income tax, affected participants must pay a 20% "excise" tax and penalty interest (at a rate of the federal underpayment rate plus 1%) on the amounts deferred. Further, all other plans of the same type in which the employee participates will be deemed to have failed and the same sanctions will apply.

Arrangements Covered

A "nonqualified deferred compensation plan" generally includes any arrangement that provides a "service provider" (employees, directors and certain independent contractors) with a legally binding right to receive compensation payable in a taxable year after the compensation is earned. It does not matter if the legally binding right is fixed or subject to vesting. However, in perhaps the most important exception to Code section 409A, compensation will not be considered "deferred" if it is distributed within 2-1/2 months after the close of the taxable year in which the amount is earned and becomes vested.

Plans Included. Elective deferral plans, nonqualified defined contribution and defined benefit plans, SERPs, certain SARs, phantom stock, certain stock options, 401(k) "wrap" plans, excess benefit plans, bonus and incentive deferral arrangements (unless paid within 2-1/2 months of bonus period), certain severance arrangements, executive employment agreements that contain a deferral provision, certain split-dollar life insurance, arrangements covering nonemployees such as directors, 457(f) plans, certain commission arrangements, change in control agreements, certain independent contractor agreements, certain medical or other reimbursement arrangements including tax gross-up, and any other arrangements providing for the payment of compensation in the future. Unwritten plans or arrangements may also be subject to Code section 409A.

Plans Excluded. Tax-qualified plans, certain tax deferred annuities, simplified employee pensions, "simple" retirement accounts, 457(b) plans, 415(m) plans, incentive stock options, certain fair market value stock appreciation rights and nonqualified stock options, certain restricted stock plans, certain severance arrangements, certain split-dollar life insurance, and any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan, and any arrangement under which an active participant makes deductible contributions to a trust described in Code section 501(c)(18).

General Compliance Obligations

Deferral Elections. An "initial deferral election" must be made before the beginning of the taxable year in which the deferred compensation is earned. A plan may allow an employee to make a mid-year election in the first year of participation, if the election is made within the first 30 days of eligibility and applies to compensation paid for services performed after the election. An initial deferral election must include an election as to the eventual time and form of payment of the deferred compensation. Plans without elections must specify the time and form of payment on grant.

There is an exception for performance-based compensation in which an initial deferral election may be made on or before six months prior to the end of the applicable performance period (which must be at least 12 months long), provided that the employee performs services continuously from the later of the beginning of the performance period or the date the performance criteria are established, through the date of the election. The election may not, however, be made after any amount of such compensation is calculable and substantially certain to be paid.

Distributions. Distributions may not be made prior to the occurrence of one of the following events (which must be specified in the plan): (a) separation from service; (b) disability; (c) death; (d) a specified time or pursuant to a fixed schedule provided in the plan on the date the compensation is deferred; (e) change in control; or (f) unforeseeable emergency. Any payment schedule occurring after a triggering event must comply with the fixed schedule rules (which, amongst other rules, requires objectively determinable amounts be paid at objectively determinable times).

Accelerated Distributions. A plan may not permit the acceleration of the time or schedule of any payment under the plan, unless specifically allowed under IRS guidance. Examples of permitted accelerations include certain payments to a spouse upon divorce, paying FICA taxes or liquidating a plan in complete termination (under certain circumstances).

Funding. While "normal rabbi trusts," are permitted, Code section 409A imposes sanctions on both offshore and "springing" rabbi trusts (*i.e.*, trusts in which the assets are used to "fund" deferred compensation arrangements in the event of a downturn in the financial health of the plan sponsor).

Typical Revisions

Certain types of revisions are often required to bring a plan into compliance with Code section 409A. Other revisions are more discretionary, but are beneficial from a contractual standpoint and must be accurately drafted in order to ensure compliance. A few examples of typical revisions include the following:

- Removing provisions that provide discretion as to when to receive or "take" deferred compensation
- Removing provisions that provide discretion as to the time when a stock option may be exercised
- Removing (or revising) provisions that allow for unconditional termination by the plan provider
- Removing (or revising) discretionary acceleration provisions
- Adding specific 409A defined terms, such as "Separation from Service," "Change in Control" and "Disability"

Steps to Take

Because all plans must be in compliance by December 31, 2008, time is of the essence. As a result, we urge you to:

1. Identify all arrangements that may fall into the "deferred compensation" category. If you are unsure whether a certain arrangement falls into the realm of Code section 409A, we would be happy to review the plan for you.
2. Determine whether any and all such arrangements currently comply with Code section 409A (or are otherwise exempted or grandfathered).
3. If any arrangement is not in compliance with Code section 409A, decide how you would like to amend the plan to comply. Often, there are various options with respect to how a plan may operate, yet still comply with Code section 409A.
4. Implement your decisions by amending the plan to comply with Code section 409A.

We would be happy to assist you with these steps, as well as communicating the effects and implications of such revisions to the participants in the affected plans.

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