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October 2005 • Vol 2, Issue 1 • www.gklaw.com

Taxation & Employee Benefits Update

Abstract: On September 29, the Treasury Department and IRS issued proposed regulations on deferred compensation under Section 409A of the Internal Revenue Code.

Following are key points that all employers should be aware of to ensure that their deferred compensation plans comply with the law.

The following is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

What Your Company Should Do Now in Response to the Proposed Section 409A Regulations

By Debra Koenig & Lecia Johnson

What is Section 409A of the Internal Revenue Code?

Section 409A provides very specific limitations on deferred compensation arrangements, with significant penalties for failure to comply. Section 409A is broad in its reach, and affects most nonqualified compensation plans and arrangements of private and public companies, including severance plans.

In general, §409A (i) provides detailed rules for the timing of deferral elections, (ii) prohibits acceleration of payments of deferred compensation, (iii) permits payments only upon the occurrence of certain events, and (iv) substantially limits the ability to make further deferrals. Section 409A and the guidance issued by the Internal Revenue Service are so restrictive that most current plans will need to be revised to comply, unless they meet narrow grandfather provisions.

What happens if a plan violates Section 409A of the Code?

A violation of §409A can accelerate the inclusion of income and result in a 20% penalty tax, paid by the employee, over and above the income tax owed. In addition, these consequences may apply not only to the offending plan or arrangement, but also to similar plans or arrangements of the same employer, even if they comply with §409A.

Why should I focus on Section 409A now?

On September 29, 2005, the IRS released *proposed* regulations under §409A (the Regulations). They are the IRS' most detailed guidance to date about applying §409A to myriad situations. Although the Regulations are proposed, they can be relied on until they are finalized.

When must my plan comply with Section 409A?

Previous IRS guidance issued late in 2004 gave companies until December 31, 2005 to bring their deferred compensation plans into compliance with §409A. The Regulations extend this deadline, and give companies until December 31, 2006 to make *written* amendments to their plans and arrangements to comply with §409A. *However, companies must comply in good faith with §409A in the interim; failure to do so results in immediate taxation of the compensation and imposition of the 20% penalty.* Companies that comply with the Regulations are deemed to be acting in good faith. *Therefore, we recommend that our clients review their plans, and make necessary changes, by year-end 2005 in appropriate situations.* That way, employers will have a written document that sets forth the rules that need to be followed to comply with §409A.

Companies have until only December 31, 2005, however, to take advantage of a transitional rule in the IRS' 2004 guidance. This allows companies to terminate plans, or participants to terminate participation in a plan or cancel deferral elections, without penalty, if they do so by December 31, 2005.

Finally, the IRS' 2004 guidance gave participants the ability to make changes to their distribution elections, or to make initial elections for previously deferred amounts, until December 31, 2005. The Regulations have also extended this deadline and give participants until December 31, 2006 to make such decisions. However, in 2006, an

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election cannot change a payment election (a) to defer a payment that would otherwise be made in 2006 or (b) to otherwise cause a payment to be made in 2006. An election to further defer a distribution that would otherwise be made in 2006 still must be made by December 31, 2005.

Should I be concerned that the IRS will audit my plans for Section 409A compliance?

Yes. As part of its executive compensation initiative implemented for all audits, the IRS is already training its agents in the intricacies of §409A. Audits of taxable years 2005 and forward will include a review of plans and arrangements for compliance with §409A (as well as compliance with many other provisions of the Code that govern compensation).

What kinds of companies have to worry about compliance with Section 409A?

For-profit corporations (both public and private), not-for-profit corporations and governmental entities that sponsor §457(f) plans, and partnerships and limited liability companies all should review any "deferred compensation plans" for compliance with §409A.

What are "deferred compensation plans"?

The definition of "deferred compensation plans" is extremely broad and can include plans or arrangements of the following types:

- Elective deferred compensation plans (e.g., salary and bonus deferral programs)
- Non-elective deferred compensation plans (e.g., SERPs)
- Certain provisions in employment and change in control agreements (e.g., severance upon a termination of employment)
- Salary continuation plans
- 457(f) arrangements (for non-profit organizations or governmental entities)
- Restricted stock units (RSUs) and phantom stock
- Discounted stock options
- Certain stock appreciation rights (SARs)
- Severance plans
- Certain endorsement split dollar insurance arrangements

Does Section 409A apply to all of my "deferred compensation plans"?

No. Section 409A contains grandfather rules and transition provisions that protect certain plans. In general, §409A does not apply to amounts deferred prior to December 31, 2004, as long as:

- the amounts were earned and vested as of December 31, 2004; and
- the plan or arrangement is not materially modified after October 3, 2004 (except if the modification is to comply with §409A). What constitutes a "material modification" is extensively defined in the Regulations. In general, a modification of a plan is material if a benefit or right existing as of October 3, 2004 is materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned or vested prior to January 1, 2005.

In addition, earnings credited to such grandfathered amounts are not subject to §409A.

Does Section 409A only apply to deferred compensation plans covering employees?

No. Section 409A also targets plans or arrangements for non-employee directors and certain independent contractors.

What should my company do now?

First, you should determine if you have any plans or arrangements that may be subject to §409A.

Second, if you do, contact your attorney or adviser to discuss the next steps.

In general, we recommend that plans and arrangements be reviewed and any necessary modifications be made by December 31, 2005, if possible. However, so long as the plan or arrangement is operated in good faith compliance with §409A and the Regulations, your company has until December 31, 2006 to amend its plans. An important exception is that all terminations of plans, terminations of plan participation by individuals, and cancellations of existing deferral elections must be completed by December 31, 2005, or §409A will apply.

Where can I obtain additional information about Section 409A?

A detailed discussion of §409A and the Regulations can be found on our website at www.gklaw.com/docs/409A.cfm.

If you would like more information, please contact Debra Koenig (dkoenig@gklaw.com), Lecia Johnson (ljohnson@gklaw.com) or another Godfrey & Kahn attorney. ◆