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Tax & Employee Benefits Update

Abstract: On April 10, 2007, the IRS issued final 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.

What Your Company Should Do Now in Response to the Final Deferred Compensation Regulations Under Section 409A

By Debra Koenig & Lecia Johnson

What is Section 409A of the Internal Revenue Code?

Section 409A was enacted in 2004 to limit perceived abuses in deferred compensation and provide 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, Section 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.

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)
- Employment and change in control agreements
- Salary continuation plans
- Section 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 bonus or incentive plans
- Certain split dollar insurance arrangements

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

A violation of Section 409A can accelerate the employee’s inclusion of income and result in a 20% penalty tax for the employee over and above the income tax owed, as well as interest on such amounts if the tax is not paid in the proper tax year. 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 Section 409A.

Why should I focus on Section 409A now?

On April 10, 2007, the Internal Revenue Service issued final regulations under Section 409A. This is the IRS’ most detailed statement to date as to how Section 409A applies. While the regulations are effective as of January 1, 2008, they can be relied upon retroactively for taxable years before 2008. The regulations require that all plans or arrangements subject to Section 409A must be documented in writing **no later than December 31, 2007** and such documents must comply with the rules of Section 409A by such time.

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Final 409A Regulations (continued)

Prior to the issuance of the final regulations, the IRS had issued proposed regulations in October 2005. The final regulations generally adopt the provisions of the proposed regulations, although further guidance and clarity has been provided in many areas, including, but not limited to:

- Which stock options and SARs are exempt from Section 409A
- Permissible extensions of exercise periods on otherwise exempt stock options and SARs
- How to structure severance arrangements to be exempt from or comply with Section 409A
- What deferred compensation provisions must be documented in writing to comply with Section 409A

> *"All plans and arrangements must be reviewed and necessary modifications must be made prior to January 1, 2008."*

When must my plan comply with Section 409A?

As mentioned above, companies have until **December 31, 2007** to bring their plans into compliance with Section 409A. However, companies must comply in good faith with Section 409A in the interim; failure to do so results in the 20% penalty. It is extremely important that you review your plans with the help of legal counsel, and make necessary changes by year-end 2007. In addition, companies only have until December 31, 2007 to take advantage of transitional guidance which allows both employers and employees to make certain distribution elections with respect to plans or arrangements subject to Section 409A.

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

Yes. As part of the IRS executive compensation initiative implemented for all audits, the IRS is already training its agents in the intricacies of Section 409A. Audits of taxable years 2005 and forward will include a review of plans and arrangements for compliance with Section 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, and partnerships and limited liability companies all should review any "deferred compensation plans" for compliance with Section 409A.

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, Section 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 Section 409A). What constitutes a "material modification" is 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 Section 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?

You, along with counsel, should determine if you have any plans or arrangements that may be subject to Section 409A. If you do, you should discuss with counsel what modifications, if any, are required. Even though you may have previously reviewed and/or modified an arrangement in reliance on the earlier guidance, we recommend that all arrangements be reviewed in light of the final regulations.

Important: All plans and arrangements must be reviewed and necessary modifications must be made prior to January 1, 2008.

Where can I obtain additional information about Section 409A?

Detailed information regarding Section 409A and the regulations that have been issued since its enactment (both proposed and final) can be found on our website at http://www.gklaw.com/docs/409Ainfo.cfm.

If you have any questions about Section 409A or require assistance, please contact Debra Koenig (dkoenig@gklaw.com or 414-287-9476), Lecia Johnson (ljohnson@gklaw.com or 414-287-9319), or another Godfrey & Kahn attorney. ◆