

EMPLOYEE BENEFITS & COMPENSATION ALERT

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Important Reminder: Deadline Approaching for Amending Deferred Compensation Arrangements Under Section 409A

The deadline is fast approaching for amending deferred compensation arrangements that are subject to Section 409A of the Internal Revenue Code. All covered deferred compensation arrangements must be amended on or before **December 31, 2008**.

Following is general background information on Section 409A and practical tips and guidance on actions that should be taken immediately in light of the upcoming deadline.

General Background on Section 409A

Section 409A generally provides that amounts deferred under a "nonqualified deferred compensation plan" are currently includible in taxable income if not subject to a substantial risk of forfeiture, unless the plan meets specified documentation and operational requirements. Failure to comply with the applicable requirements of Section 409A can result in severe federal and state income tax consequences, including a 20% penalty tax imposed on the employee or other service provider, such as an independent contractor.

Deferred compensation arrangements that were in place before October 4, 2004 are grandfathered, provided they are not materially modified after such date. However, the old rules apply to compensation deferred under such arrangements only to the extent it accrued **and** vested before December 31, 2004. Amounts accrued or vested after such date are subject to 409A.

All Arrangements Subject to Section 409A Must Be Fully Compliant by January 1, 2009

The IRS issued Notice 2007-86 which extended the effective date of the final Section 409A regulations to January 1, 2009. This means that any existing deferred compensation arrangement that is subject to Section 409A must be operated in accordance with a legally binding written document that complies with all the rules set forth in the final Section 409A regulations on or before December 31, 2008. In most cases, compliance with Section 409A will require

amendments to, or restatements of, existing documents or agreements; in some instances it will require documenting previously unwritten arrangements. Notice 2007-86 also provides helpful transition guidance that can be relied upon during the remaining 2008 transition period.

What Employers Should Be Doing Now

Employers and other "service recipients" should review all of their formal and informal compensatory arrangements to identify those that may be subject to Section 409A and that may require action to bring the arrangements into compliance with Section 409A by this year end. In addition, employers and other service recipients should consider whether, and to what extent, they can take advantage of transition relief expiring on December 31, 2008. After 2008, a nonqualified deferred compensation arrangement that is subject to Section 409A but is unwritten or noncompliant with the final Section 409A regulations may result in immediate income inclusion of the deferred amount and trigger the 20% additional tax and interest and other tax consequences for the employee or other service provider.

Practical Tips

Many Common Compensation Arrangements May Be Nonqualified Deferred Compensation Plans Subject to Section 409A. Section 409A defines "nonqualified deferred compensation plan" so broadly that any compensation arrangement, formal or informal, that results in the deferral of compensation into a subsequent taxable year may be covered, even agreements that cover only one person. Common types of arrangements that may be subject to Section 409A include the following:

- ◆ Offer letters
- ◆ Traditional deferred compensation plans (e.g., SERP)
- ◆ Employment, change in control, and severance agreements
- ◆ Reimbursement agreements
- ◆ Retention agreements
- ◆ Discounted stock options and stock appreciation rights
- ◆ Phantom stock or phantom units
- ◆ Restricted stock units and certain other equity compensation arrangements
- ◆ Annual and multi-year bonus plans and long-term incentive plans
- ◆ Severance plans
- ◆ Salary continuation arrangements
- ◆ 12-month payment arrangements for school teachers
- ◆ Earn-outs and other arrangements entered into in connection with business transactions
- ◆ Split-dollar life insurance arrangements

Typical problem areas include:

- ◆ Noncompliant elections to defer, accelerate, or otherwise change the manner of payment.
- ◆ Noncompliant, or failure to adopt, 409A definitions of "Good Reason," "Change in Control," "Separation from Service," and/or "Disability."

- ◆ Provisions for payout of the same benefit in different time or manner, depending upon the reason for employment termination.
- ◆ No timing requirements regarding payment of annual bonuses, expense reimbursements, and in-kind benefits.
- ◆ Failure to include a six-month delay for severance payments to “specified employees” of publicly traded corporations.
- ◆ Failure to include an acceptable valuation method for stock not readily tradable on an established securities market.

Utilize Transition Relief. Employers and other service recipients should act now to take advantage of any transition relief relevant to them before this relief expires at year end. Potential relief expiring on December 31, 2008 includes:

Change in Payment Elections. With respect to the time and form of payment of amounts subject to Section 409A, a plan may provide, or be amended to provide, for new payment elections on or before December 31, 2008 without regard to the one-year advance notice, five-year delay and no acceleration limitations of Section 409A. These new payment elections from service providers should be obtained before the end of this year. Note, however, that any election changes made in 2008 cannot delay payments that would otherwise be made in 2008 or accelerate payments into 2008 that would otherwise not be paid in 2008.

Change Stock Options and SARs to Provide Fixed Payment Terms. Employers and other service recipients may amend most outstanding stock options and stock appreciation rights subject to Section 409A to provide fixed payment terms or to permit holders of stock rights to elect fixed payment terms consistent with Section 409A, provided that the awards are amended, and any elections are made, on or before December 31, 2008, subject to the same timing limitations noted above for change in payment elections.

Exchange Discounted Stock Options or SARs for Non-Discounted Awards. With respect to the substitution of a non-discounted stock option or stock appreciation right for a discounted stock option or stock appreciation right, this exchange may occur only to the extent that a cancellation and re-issuance does not result in the cancellation of a deferral in exchange for cash or vested property in the same year. The guidance included in the preamble to the proposed Section 409A regulations continues to apply. However, this transition relief does not apply to discounted stock options that are covered by Section 409A and held by individuals who were subject to Section 16(a) of the Securities Exchange Act of 1934 at the time the discounted options were granted—the deadline to correct these awards was December 31, 2006.

Deadline to Modify Good Reason Conditions. Notice 2007-78 contains guidance on whether modifying good reason conditions in an employment agreement will allow such conditions to continue to result in an involuntary separation from service for purposes of specific regulatory exceptions to Section 409A (often referred to as the “short-term deferral” and the “two-year, two-times” rules). If so, modifications may be required by December 31, 2008.

Finalize Steps Needed for Document Compliance. Employers and other service recipients should take immediate action to meet the document compliance deadline, including adopting all necessary amendments no later than December 31, 2008. Depending on plan terms or corporate procedures, board of directors approval or consent of covered employees, directors or others may be needed to adopt amendments and implement operational changes. Public companies need to comply with all applicable shareholder approval and reporting and disclosure obligations in current and periodic reports (Form 8-K, Form 10-Q and

Form 10-K) and in proxy statements.

Adopt Compliance Controls for Future Arrangements. The final regulations under Section 409A and IRS guidance contain a number of documentation requirements and potential traps. To promote ongoing compliance with 409A, employers and other service recipients should establish controls. For example, employers should implement procedures to review drafts of new compensation plans, agreements and arrangements, or amendments to existing plans, agreements or arrangements, to verify Section 409A compliance *before* adopting or amending them. They might also consider offering training for personnel responsible for negotiating compensatory arrangements to ensure that those personnel have a basic understanding of all applicable requirements under Section 409A.

Implement Operational Requirements. Employers and other service recipients must properly implement the operational requirements of the final Section 409A regulations within their systems, administrative forms, communications and other sources on and after January 1, 2009. This may include contacting service providers, such as third party administrators, recordkeepers and trustees, to verify their compliance and to finalize any necessary coordination.