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Employee Benefits and Executive Compensation Practice Group
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Alert

Required Changes to Deferred Compensation Plans

IRS regulations regarding Section 409A of the Internal Revenue Code will become effective on January 1, 2009. By that date, all plans providing for compensation governed by 409A's new statutory and regulatory restrictions will need to be made compliant, both in form and in operation, with Section 409A's strict rules. Failure to comply with 409A's rules, either in form or in operation, can result in taxable income to employees or other service providers before the compensation is otherwise payable to them, as well as the imposition of a particularly onerous additional 20% income tax penalty and possible interest charges.

Reach of Statute is Broad – Beyond "Traditional" Deferred Compensation

Section 409A governs most "non-qualified" deferred compensation provided by employers to their employees and independent contractors (e.g., consultants and nonemployee directors), including traditional deferred compensation plans, excess benefit plans, and SERPs (supplemental executive retirement plans). But 409A also governs many other payments of compensation that are not normally thought of as providing "deferred" compensation, including payments made upon severance from employment (either through severance pay plans, or pursuant to the terms of employment agreements), expense reimbursements, bonus awards and payments upon death or disability. Section 409A also imposes strict rules with respect to certain arrangements providing for stock or other equity compensation. Even where plans and arrangements are designed to meet in operation the Section 409A rules regarding the timing of payments, 409A's strict "form" requirements can require modification of the governing documentation to ensure full compliance.

Additional Rules for Not-for-Profit Employers

For not-for-profit employers, additional rules apply to deferred compensation (under Internal Revenue Code Section 457), that are even stricter than some of the rules that apply to for-profit employers. Recent IRS guidance has indicated that several of the Section 457 rules are anticipated to be interpreted in a manner consistent with the new 409A rules (which in many cases differ significantly from prior Section 457 interpretations). Accordingly, plans and arrangements for not-for-profit employers will often need revision in order to avoid unintended violation of either the 457 or 409A rules.

Transition Rules Ending – Employer Action Required By Year-End

During 2008, special transition rules apply under Section 409A, so that plans and arrangements can be revised in order to come into compliance with the 409A rules. Effective January 1, 2009, the new rules will be fully in effect, and the ability to change the form or timing of payments of deferred compensation and remain in compliance with 409A (and thereby avoid the onerous tax results that come from noncompliance) will be severely limited.

Accordingly, **immediate attention is required** by all employers that maintain arrangements that may be subject to the rules under 409A (referred to here as non-qualified deferred compensation plans, or NQDCPs), as the deadline for compliance with Section 409A is fast approaching, and the consequences of a failure to comply can be significant.

IMPORTANT ACTIONS NEED TO BE TAKEN NOW

The transition relief period ends on December 31, 2008 and the effective date for plan document and operational compliance with the final Section 409A regulations is January 1, 2009. It is imperative that plan sponsors continue to review their deferred compensation plans and arrangements for compliance with Section 409A so that such compliance can be implemented (including, as necessary, the adoption of amendments to plans and agreements) by the year-end deadline. To accomplish that objective, we recommend that plan sponsors take (or, if already started, complete) the following steps:

- *Identify All Impacted Arrangements*. Identify and review all plans, agreements and arrangements (other than tax qualified plans) that may provide deferred compensation to their employees or independent contractors (e.g., consultants). For example, deferred compensation subject to Section 409A may exist in employment agreements, severance programs and agreements, equity award plans, reimbursement arrangements and, of course, elective and nonelective deferred compensation plans and SERPs. Indeed, most employment agreements include one or more provisions governed by Section 409A with regard to the timing of payments, particularly if they provide for separation-related payments and taxable reimbursements.

- *Determine Availability of Exemptions*. Determine if the identified NQDCPs provide compensation that is (or can be structured to be) exempt from Section 409A. For instance, many annual bonus plans as well as certain stock option and restricted stock plans should be exempt from 409A.

- *Check Time and Form of Payment Elections*. For NQDCPs that are subject to Section 409A, determine whether the elections to defer compensation and the provisions governing the time and form of payment meet the requirements of 409A. In doing so, remember that the special transition period opportunity to modify the time and form of payment ends on December 31, 2008.

- *Review Procedures.* Review operational and administrative procedures supporting the NQDCPs to determine if 409A compliance will require any changes to such procedures.

- *Obtain Approvals.* Leave time to negotiate and draft plan changes and obtain approvals and consents.

The key elements of the most recent transition relief guidance issued by the IRS are described below.

Plan Amendment/Operational Compliance

- Plan sponsors must amend their NQDCPs to fully comply with Section 409A by December 31, 2008.

- Until December 31, 2008, plan sponsors must operate their plans in accordance with Section 409A and the applicable provisions of IRS Notice 2005-1, and if an issue is not addressed in such Notice, in accordance with a good faith, reasonable interpretation of Section 409A. For 2008, compliance with the Section 409A final regulations will be deemed a good faith, reasonable interpretation of Section 409A.

Required Changes to Deferred Compensation Plans

Changes in Payment Elections

- *Special Transition Relief.* Participants and plan sponsors are permitted to change the time and form of the payment of deferred compensation subject to Section 409A on or before December 31, 2008, provided any such election made in 2008 may not cause an amount otherwise payable in 2008 to be paid in a later year or cause an amount payable in a later year to be paid in 2008.

- This special transition payment election opportunity offers an exception from (i) restrictions under Section 409A that generally prohibit the acceleration of the timing of a deferred compensation payment and (ii) the imposition of additional payment conditions if the timing or form of payment is changed after an amount is initially deferred.

- After 2008, any change in the timing or form of payment of benefits under a NQDCP subject to Section 409A will need to comply with the strict subsequent deferral election and anti-acceleration rules under Section 409A.

Plans "Linked" With Qualified Plans

- Through 2008, participants in a NQDCP that provides for benefits payable at the same time or in the same form as benefits are paid under a tax-qualified (Code Section 401(a)) retirement plan may continue to do so, without violating the payment election and timing rules under Section 409A, provided such "linked" payment election is made in accordance with the terms of the NQDCP as in effect on October 3, 2004. This transition relief also applies to linked payment elections under Code Section 403(b) and 457(b) eligible plans and foreign broad-based plans.

- Thus, in accordance with this transition relief, a participant's election of a time and form of benefit payment under a qualified plan generally can apply to the payment of his or her benefits under a related NQDCP provided the non-qualified plan payment is made or commences on or before December 31, 2008, without violating Section 409A (though other constructive receipt concerns may still apply).

- Beginning in 2009, plan sponsors will need to "de-link" their NQDCPs from any related qualified plan and provide (in accordance with the transition rule for changes in payment elections) for detailed payment rules, and, where offered, separate benefit payment elections in the NQDCPs.

Discounted Stock Options and SARs

- If a non-qualified stock option or stock appreciation right has an exercise price as of the date the stock right is granted that is less than the fair market value of the underlying stock on such date (a discounted stock right), then the stock right will be subject to Section 409A. A stock right that is subject to Section 409A will need to be modified by December 31, 2008 to provide for fixed payment (or exercise) dates consistent with the permissible payment events under Section 409A.

- Until December 31, 2008, discounted stock rights may be cancelled and reissued in the form of non-discounted stock rights (i.e., with an exercise price at least equal to the stock's fair market value on the original grant date of the replaced stock rights), which will enable the stock rights to be exempt from Section 409A. This transition relief does not apply to certain discounted stock rights held by insiders of public companies that did not timely and properly report such stock rights on their financial statements.
- A discounted stock right that is not modified by December 31, 2008 either to be exempt from Section 409A (as a non-discounted stock right) or to provide for 409A-compliant fixed payment terms will in many instances violate Section 409A and thus can subject the holder of the stock right to the onerous tax and penalty consequences under 409A.

This alert is for general informational purposes only and should not be construed as specific legal advice.

Members of our Executive Compensation and Employee Benefits and Tax Practice Groups are available to help plan sponsors implement the above recommended actions to be taken. Please let any of the attorneys listed below know if we can be of assistance to you.

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