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Nonqualified Deferred Compensation Plans

2007 Year End Section 409A Relief Issued by IRS is Limited

The Internal Revenue Service (IRS) issued two hundred pages of final regulations interpreting Section 409A of the Internal Revenue Code of 1986 this past April. Under the final regulations, deferred compensation plans were required to be in documentary and operational compliance with Section 409A by the end of 2007. On September 10, 2007, the IRS provided a limited extension to the December 31, 2007 compliance deadline for Section 409A in Notice 2007-78. This relief did not go as far as many had hoped because it did not extend the January 1, 2008 effective date of the final regulations. In addition, prior transition relief that permitted a plan to comply with Section 409A in "good faith" was not extended.

The Compliance Deadlines In A Nutshell

- Plans must specify the time and manner of payment of deferred compensation in writing by December 31, 2007.
- Nonqualified deferred compensation plans and arrangements must operate in compliance with the new rules by January 1, 2008.
- All of the technical rules mandated by Section 409A do not have to be documented by December 31, 2007. Nonetheless, much of the analysis regarding plan design and employee elections must be completed before the end of this year.
- Plan amendments documenting compliance with Section 409A and the regulations thereunder must be adopted by the end of 2008 and must be retroactively effective to January 1, 2008.

Background of Section 409A

Section 409A requires all nonqualified deferred compensation plans and agreements to comply with a host of new rules in order for compensation to be deferred to a future date. This provision touches all forms of deferred compensation--from stock awards to separation pay. While many arrangements are exempt from Section 409A, most notably traditional retirement plans qualified under Section 401(a) (for example 401(k) plans and pension plans), plans maintained by tax exempt or governmental employers under Section 457(b) and certain welfare plans, Section 409A applies to most arrangements that defer the payment of compensation to a later year where the employee has a legally binding right to the compensation in the current year.

Failure to comply with Section 409A results in the current taxation of all amounts deferred under the plan to the extent not subject to a substantial risk of forfeiture (and not previously included in gross income), the imposition of a twenty percent (20%) additional income tax, and

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interest and penalties. In addition, all “similar plans” as defined under the Section 409A regulations that an employee participates in are aggregated, and the employee is subject to the same adverse tax treatment with respect to all similar plans even if only one of the plans fails to satisfy the Section 409A requirements.

Employers only have a few months left before the end of 2007 to identify all plans and agreements, whether currently in writing or not, that are subject to Section 409A. In addition, because plans must operate in compliance with Section 409A beginning January 1, 2008, those responsible for plan administration must have an overall understanding of Section 409A to ensure that operational errors do not trigger noncompliance. Although the IRS announced the creation of a voluntary correction program in Notice 2007-78 that will limit the taxes due for operational errors, the program will only cover “unintentional errors” that are corrected in the same taxable year in which the error occurred.

If you have not already done so, it is critical that you perform an assessment of your deferred compensation plans and arrangements, stock option plans, employment agreements and severance plans, to name a few, and **decide now whether your deferred compensation plans and arrangements need to be amended by December 31, 2007.** Given the complexity of the Section 409A regulations and the limited time to perform the required analysis and make the necessary changes, if you have not already done so, you should focus on this compliance issue now.

Steps You Need to Take

Step One: Identify all of the plans and arrangements that provide for compensation to be paid in a subsequent year, including arrangements held in offshore trusts.

Step Two: Schedule time on the Board’s year end calendar to address amendments to comply with Section 409A. You may need to consider having a special meeting.

Step Three: Identify plans that are grandfathered under prior law because the compensation was earned and vested before 2005 and decide whether to preserve the grandfathered treatment or elect to comply with Section 409A. A material modification of a grandfathered plan after October 3, 2004 may have caused the plan to lose grandfathered treatment.

Step Four: Identify plans that fall within one of the exceptions to Section 409A so that you can set them aside because they do not have to be amended.

For example, the following plans generally are exempt from Section 409A:

- A plan that provides for a payment within two and one half months after the close of the year in which the right to the payment became substantially vested.
- A plan that covers an “independent contractor” as defined under the Section 409A regulations.
- A separation pay plan that provides payments following an involuntary termination of employment or a voluntary termination of employment for “good reason” as defined under the Section 409A regulations and that satisfies other specific requirements.
- Nondiscounted incentive stock options and nonqualified stock options.
- Nondiscounted Stock Appreciation Rights (SARs).
- Qualified retirement plans.
- A deferred compensation plan subject to Section 457(b).
- Certain welfare plans.

Step Five: For plans that **do not** fall within an exception, identify the plans that currently do not specify a time and manner of payment and draft required design changes and amendments.

