

Deadline Looms for Deferred Compensation Plans

Section 409A of the Internal Revenue Code (IRC) was added in October 2004 as part of the American Jobs Creation Act to address concerns about reported abuses of nonqualified deferred compensation plans. Final section 409A regulations were issued in April 2007. See T.D. 9321, 72 Fed. Reg. 19234 (April 17, 2007) at www.ustreas.gov/press/releases/reports/td9321.pdf. IRS Notice 2007-78 originally established a deadline of December 31, 2007, for plan documents to comply with the final regulations. IRS Notice 2007-86 extended this document compliance deadline one year to December 31, 2008. Since the enactment of section 409A, the IRS has always expected plan sponsors to comply with the law in *operation* of the plan but has not required that plans be *amended*. Now, however, *affected plans that are out of compliance with section 409A must be amended to comply no later than December 31, 2008.*

The results of failure to comply can be quite punitive. The participant-employee would be subject to the immediate acceleration of vested deferred compensation into the current year for tax purposes, even if the compensation is not actually paid out at that time. Additional taxes and interest would also apply. The requirements of section 409A are in addition to the already existing rules governing deferred compensation such as economic benefit, constructive receipt, and IRC section 83 (involving taxation of property transferred in connection with the performance of services).

Which Plans Are Covered

Section 409A sets forth new rules applicable

to “non-qualified” deferred compensation plans. Note that this does *not* include “qualified” plans such as pensions, 401(k) plans, and profit sharing plans. Section 409A also does not apply to section 403(b) plans (retirement plans offered by public employers and tax-exempt organizations) or certain welfare benefit plans (e.g., bona fide sick leave and vacation plans).

Plans covered include traditional elective deferred compensation plans and non-elective plans (e.g., SERPs [Supplemental Executive Retirement Plans] and excess benefit plans), but section 409A can also encompass the following plans, with various exceptions: severance packages; change-in-control agreements; non-qualified stock options issued at a discount; stock appreciation rights and phantom stock plans; bonus plans; split dollar agreements; employment, director, and consulting agreements; and section 457(f) plans. Section 409A covers deferred compensation arrangements not only for executives and other employees, but also for independent contractors, outside directors, and partners.

Section 409A provides certain exemptions from coverage. All plans are exempt that defer compensation for no more than two and a half months after the close of the year in which the deferred compensation vests. There is also an exemption for certain severance benefit plans that applies only to involuntary separations (or to separations under a “window” plan). This exemption applies only to the extent that the severance benefit: (1) does not exceed the lesser of: (a) two times the employee’s annualized compensation in the year before the severance; or (b) two times the qualified plan includible compensation limit under section

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401(a)(17) for the year the separation occurs (e.g., for a separation in 2008, $2 \times \$230,000 = \$460,000$); and (2) is paid out no later than the last day of the second calendar year after the severance occurs (e.g., no later than December 31, 2010, for a separation in 2008).

Section 409A applies to all amounts deferred after December 31, 2004. Deferred compensation that was earned *and vested* before January 1, 2005 (plus future earnings on such amounts), is exempt unless the plan under which it was deferred is modified materially after October 3, 2004. So it is possible, under the grandfathering rules, for a portion of a participant's account to be subject to section 409A and another portion to be exempt. It is also possible for some participants to be wholly exempt (because they had no further deferrals or vesting after the grandfathering date) and others in the same plan to be wholly subject (because they only began to defer after the grandfathering date).

Compliance During 2008

During 2008, plan sponsors are not required to comply with the requirements of the final regulations. Instead, they must operate affected plans in compliance with the plan's terms, to the extent they are consistent with section 409A and applicable IRS guidance. See IRS Notices 2007-86 (www.irs.gov/irb/2007-46_IRB/ar11.html) and 2005-1 (www.irs.gov/irb/2005-02_IRB/ar13.html). If a plan's terms conflict with 409A or IRS guidance, plan sponsors must operate the plan in compliance with 409A. If a provision of Notice 2005-1 is inconsistent with the final regulations, plan sponsors may rely on either Notice 2005-1 or the final regulations. To the extent an issue is not addressed in Notice 2005-1 or other applicable guidance, plan sponsors must apply a reasonable, good faith interpretation of the statute. Reliance on the final regulations is treated as applying a reasonable, good faith interpretation of the statute.

Key Provisions of Section 409A

The following is a brief overview of some key provisions of section 409A:

Written Plan. A plan subject to section 409A must be in writing and, at a minimum, must specify the amounts being deferred (or a formula), the time and form of payment (including a six-month delay for payments to "key employees" of public companies on account of separation from service), and the conditions under which initial or subsequent deferral elections may be made.

Timing of Deferral Elections. For a plan into which elective deferrals may be made, the employee's election must

be made before the beginning of the year in which the services resulting in the deferred compensation are performed. There are two exceptions:

Initial Eligibility. In the year in which an employee first becomes eligible to participate in a plan, the employee may make a deferral election, with respect to future compensation only. The election must be made within 30 days after initial eligibility.

Performance-based Compensation. Deferral elections with respect to "performance-based compensation" for services performed over a period of at least 12 months are permitted as late as six months before the end of the service period.

Restrictions on Distributions. Distributions under section 409A may be made only on death, separation from service, disability, a specific time or schedule, an unforeseeable emergency, or a change in ownership or control of a corporation. The time and form of distribution must be specified at the time of deferral and can be altered later only under certain very limited conditions.

Re-deferral or Acceleration of Benefits. Once a deferral election has been made, it can be "re-deferred" only under certain specific conditions. Similarly, acceleration of distribution of benefits can occur only in limited circumstances. (Example: Having made a deferral election, Participant A is scheduled to receive benefits under the plan on January 1, 2012. The plan can allow A to "re-defer" receipt to a future date, such as January 1, 2020, as long as the election does not take effect for at least 12 months, and, with certain limited exceptions, the re-deferral must defer receipt for at least five years.) On the other hand, accelerated vesting is allowed.

Restrictions on Funding. Section 409A adds restrictions on employers setting aside money to fund deferred compensation agreements. For example, the use of offshore trusts for this purpose is now severely limited.

Plan Aggregation. The term "plan" includes all plans of the same type in which the participant participates. Consequently, a compliance failure in one plan will result in the participant being taxed under section 409A on all the benefits provided under all the other plans in which he or she is participating that are the same type as the non-complying plan. The final 409A regulations identify nine different types of plans.

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Consequences of Non-Compliance

The consequences of failure to comply with section 409A are substantial. For a non-complying plan, the section provides for immediate taxation and an additional 20% tax on amounts deferred under the plan for the current taxable year and all preceding taxable years to the extent such amounts are not subject to a “substantial risk of forfeiture” and not previously included in income. The tax due is increased by interest at the IRS underpayment rate (currently 6% and updated every quarter in published revenue rulings), plus 1% from the year in which the amount was first deferred, or no longer subject to a substantial risk of forfeiture, if later, to the year in which it is included in income. “Substantial risk of forfeiture” means that (1) payment is conditioned on substantial future services for the employer or on the satisfaction of other conditions related to a purpose of the compensation, and (2) the possibility of forfeiture is substantial. In general, a risk of forfeiture ceases to exist when a right to payment becomes vested.

The deadline for amending plans affected by section 409A is fast approaching. The prudent attorney will survey his or her clients’ deferred compensation plans, determine whether this section applies to them, and make a plan of action to address any required changes well before the December 31, 2008, deadline.

Even though the plan amendment deadline was extended to December 31, 2008, there was no extension of the operational compliance deadline. Plans subject to section 409A must be operated in compliance with 409A requirements during 2005, 2006, 2007, and 2008. In Notice 2007-100, the IRS provided transitional relief and guidance on the correction of operational failures. The relief is limited, however. Some errors need to be corrected in the same tax year in which they occur. And the transitional relief will sunset December 31, 2009. So it is important for attorneys to advise their clients of the need to review their plans for operational compliance to take advantage of the transitional relief and correction procedures, if needed.

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