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LEGAL TOPICS

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Finally - Final Regulations Issued for Deferred Compensation Arrangements

Final regulations have recently been issued explaining the requirements of the 2004 law governing deferred compensation. In October, 2004, the new law made major changes to the rules applying to many compensation arrangements, including deferred compensation plans, employment contracts, equity arrangements, and even individual agreements by creating a new Internal Revenue Code Section 409A ("Section 409A"). On December 20, 2004, the IRS issued initial guidance interpreting Section 409A in Notice 2005-1, but many issues remained unclear. On September 29, 2005, the IRS issued proposed regulations (the "Proposed Regulations") and filled in some of the gaps. On April 17, 2007, the IRS issued final regulations (the "Final Regulations") further clarifying the application of Section 409A.

Important points:

- ⇒ Most current plans (non-qualified, retirement plans or agreements) must be amended.
- ⇒ Even individual arrangements must comply.
- ⇒ Many employment agreements providing severance pay and severance agreements may qualify for an exception.
- ⇒ Bonus and compensation arrangements that are subject to Section 409A must be in writing.
- ⇒ The consequences of failing to act can be financially disastrous for participants.
- ⇒ Employers will be subject to new reporting requirements.

Section 409A – It Probably Affects You or Your Company

Does your company utilize any of the compensation arrangements listed below for employees, directors or independent contractors (referred to as "employees" in the remainder of this article)? Do you have an employment contract that provides for severance pay and/or continued benefits following termination? If so, the arrangements should be reviewed to determine what steps may be needed to become Section 409A compliant.

- Deferred Compensation Agreements
- Salary Continuation Agreements
- Supplemental Executive Retirement Agreements ("SERP")
- Bonus and Incentive Pay Plans
- Excess Benefit Plans
- 401(k) Wrap Plans
- Employment Contracts Providing Severance Benefits
- Separation Pay Agreements
- Change in Control Separation Agreements
- Stock Option Plans and Agreements
- Stock Appreciation Rights Plans and Agreements
- Phantom Stock Arrangements
- Split Dollar Life Insurance Agreements

Section 409A now broadly defines deferred compensation as any compensation where (1) the employee obtains a legally binding right to compensation during a year (Year 1), and (2) the compensation is or may be paid in a later year (even if it is actually paid in Year 1). The Final Regulations clarified that the determination of whether compensation is deferred compensation is made at the time the legally binding right arises, so an amendment cannot be adopted later to try to fall within an exception to Section 409A application.

Important Dates and Deadlines

January 1, 2005: Effective date of Section 409A. This deadline was not extended by the Proposed or Final Regulations, and all compensation arrangements subject to Section 409A must be operated in "good faith" compliance with Section 409A after January 1, 2005.

December 31, 2007: Latest date for plan documents and agreements to be amended to comply with Section 409A.

January 1, 2008: Effective date of Final Regulations.

Dual Compliance Requirements

Section 409A requires both operational and documentary compliance. For the first time, deferred compensation arrangements covered by Section 409A must be set forth in a written document (or documents). In addition, the plan must be operated in compliance with Section 409A, which significantly restricts matters that have traditionally been discretionary and severely limits the ability to amend or terminate the plan.

Adverse Consequences Fall on the Participant

Although most deferred compensation plans are designed and prepared by companies (rather than participants), it is the participant who suffers adverse consequences if the arrangement violates Section 409A. If a deferred compensation arrangement fails to comply with the documentary or operational requirements of Section 409A, all compensation deferred under the plan for the taxable year and for all previous taxable years will be includible in the plan participant's gross income for the current taxable year. In addition, past interest and an additional 20% tax will be imposed. Also, under the plan aggregation rule, all similar plans in which the participant receives deferred compensation may be deemed out of compliance and taxed as well.

Section 409A Requirements

Section 409A contains detailed requirements governing distributions, acceleration of benefits, timing of deferral elections, elections as to timing or form of payment, changes in timing or form of payments, plan aggregation, and funding. This alert summarizes the principal requirements we believe will affect most employers.

Distribution Restrictions

Section 409A limits the types of events that can trigger a distribution from a plan to (1) separation from service; (2) disability; (3) death; (4) as necessary to meet an "unforeseeable emergency"; (5) a time specified (or pursuant to a fixed schedule) under the plan at the date of the deferral; and (6) a change in ownership or effective control of a corporation (or, by analogy, of a partnership). Each of these events has been narrowly defined by the Final Regulations, and plan documents must be drafted in accordance with the Section 409A definitions. For "key employees" of publicly traded corporations, distributions due to separation from service (including retirement) may not be made earlier than 6 months following the separation from service. Publicly traded corporations include corporations whose stock is readily tradable on an "over-the-counter" market.

Acceleration of Benefits

Plans may not permit acceleration of the time or schedule of any payment under the plans, except as provided in the Final Regulations. Common provisions allowing an early distribution with a small "haircut" or allowing companies to accelerate payments in the exercise of their discretion are now prohibited.

Timing of Deferral Elections

Deferral elections (the decision to defer payment of compensation) generally must be made no later than the close of the year prior to the year during which the services giving rise to the compensation are performed. However, there are some exceptions.

- Initial Eligibility. When a participant first becomes eligible to participate in the plan, the election to defer may be made within 30 days following the date the participant becomes eligible (but the election applies only to compensation earned after the election). However, this rule does not apply if the participant is already a participant in a similar plan. See the discussion of the plan aggregation rules below.

- Evergreen Deferral Elections. If a plan utilizes an "evergreen" election form which provides that it is effective until revoked, the election form must provide that the election becomes irrevocable for a future calendar year no later than the December 31 of the preceding calendar year.

- Performance-based Compensation. When compensation is based on established performance criteria and is earned over a period of at least 12 months, elections may be made up to six months before the end of the performance period (on or before July 1 for calendar years), but only if the amount so deferred is still not "readily ascertainable."

Elections as to Time or Form of Payments

If a plan allows a participant to elect the time or form of payment, this election must be made prior to the year in which the first services are performed. If a plan does not allow for the participant to elect the time or form of payment, then the time and form of payment should be set forth in the plan document prior to the first services being performed.

Changes in Timing or Form of Payments

Plans can allow a participant to make a subsequent election to delay or change the form of payment. However, subsequent elections may not take effect until 12 months after the date of the election. Further, in the case of distributions for events other than disability, death, or unforeseeable emergency, the first payment cannot take effect until at least 5 years from the date the payment would otherwise have been made.

Plan Aggregation Rules

For penalty purposes and for purposes of applying initial eligibility and plan termination rules, "similar" plans must be aggregated. While the Proposed Regulations contained only four classes of plans for aggregation purposes, the Final Regulations expanded the number of classes to nine, which eases the effect of the aggregation rules. The nine classes are:

1. account balance arrangements attributable to elective deferrals;
2. account balance arrangements attributable to company matching or nonelective deferrals;
3. in-kind benefit or expense reimbursement arrangements;
4. separation pay arrangements;
5. split-dollar life insurance arrangements;
6. stock rights;
7. arrangements deferring "modified foreign earned income";
8. non-account balance arrangements not already described in paragraphs 3 through 7 above; and
9. any arrangement providing for a deferral of compensation not described in paragraphs 1 through 8 above.

Funding

In most instances, if assets are set aside in an offshore trust (even a "rabbi trust"), the assets are treated as Internal Revenue Code Section 83 "property" and are taxable when set aside.

Equity-Based Compensation

Stock options and stock appreciation rights may be subject to Section 409A. Section 409A generally will not apply if either (i) the exercise price is not less than the underlying stock's fair market value on the date of grant and certain other conditions are met or (ii) exercise is limited to the "short-term deferral period" discussed below. In addition, Section 409A generally does not apply to an option qualifying as an incentive stock option under Code Section 422 or an option issued under an employee stock purchase plan under Code Section 423.

Exceptions to Section 409A

There are some exceptions to the application of Section 409A provided in the Act as well as in the Final Regulations. These include:

- <u>short-term deferrals</u> (where the arrangement <u>requires</u> that payments will be made by the later of the 15th day of the third month following the employ<u>ee</u>'s taxable year in which the payment right vests or the 15th day of the third month following the employ<u>er</u>'s taxable year in which the payment right vests),
- <u>certain severance pay and early retirement incentive programs</u> providing for limited payments during limited time periods,
- <u>certain stock options and stock appreciation rights plans</u> as mentioned above, and
- <u>certain split dollar agreements</u> if they provide death benefits only.

Determining whether an exception applies will depend upon the proper application of Section 409A and the Final Regulations to the specific facts.

Reporting Requirements

Employers who sponsor plans subject to Section 409A must report the amounts of deferrals on W-2 (employee) and 1099 (independent contractor) forms. IRS Notices and Proposed Regulations delayed the reporting requirements for 2005 and 2006. Additional guidance is expected in 2007.

Dangers of Renegotiation

In the past, employers and employees have felt free to renegotiate contracts (that include deferred compensation elements) or even amend deferred compensation plans, especially when a change in control occurs. Under Section 409A, this could trigger an impermissible "substitution" or "acceleration," with the attendant adverse tax consequences. Therefore, even consensual restructuring can have unintended tax consequences.

Practical Considerations

The IRS has informally confirmed the experience of our attorneys since the enactment of Section 409A that some amendment will be required in order for most existing plans to become compliant with Section 409A. It might be as simple as having to change the definition of "disability." But the failure to make the change would be disastrous. And, the final regulations make clear that it is not as simple as adding a "savings clause" to provide that the plan will be construed in accordance with Section 409A. Such clauses will not cause an otherwise noncompliant plan to be considered compliant.

If your company sponsors one or more of the plans or arrangements listed at the outset of this legal alert, or if you are a participant in such a plan, we advise that you consult with qualified legal counsel for advice on how to achieve compliance with Section 409A.

Please contact your Brooks Pierce advisor if you would like to discuss these issues.

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