To Our Clients and Friends **April 2, 2008**

Time To Comply With §409A Is Running Out

The final regulations under §409A, relating to the deferral of compensation of employees (other than through qualified plans) and other service providers, will be in full force and effect on January 1, 2009. Although transitional rules have ameliorated the immediate impact of §409A since its enactment in 2004, it is not anticipated that there will be further extension of the transitional relief that has been provided by the IRS through December 31, 2008.

Accordingly, nonqualified plans providing for the deferral of compensation must be documented by January 1, 2009, in a manner that complies with the final regulations, and must be operated on and after that date in accordance with the final regulations.

Transitional Relief Through 2008

Until December 31, 2008, a plan may be considered to be operated in good faith compliance with §409A even if the terms provide for discretion not generally permitted under §409A, so long as the discretion is not exercised in a manner that causes the plan to fail to meet the §409A requirements. For example: a "haircut" provision that allows an early distribution to a participant at the participant's request, if the participant accepts a forfeiture of a portion of the participant's benefits, is not permitted under §409A. However, the current existence of a haircut provision may not constitute a violation of §409A under the transitional rules so long as the discretion to allow an early distribution is not exercised. By January 1, 2009, however, such noncompliant provisions must be removed from plans.

New Payment Elections: Until December 31, 2008, plan terms may be changed to provide for new payment elections, or for a different (but non-elective) time and form of payment under the plan. The election or amendment may apply only to amounts that would not otherwise be payable in 2008, and may not cause an amount to be paid in 2008 that would not otherwise be payable in 2008. This ability to make new payment elections has proven to be a very helpful tool in resolving §409A issues under existing, noncompliant plans adopted before the enactment of §409A. For example, this transitional provision may be used until the end of this year to terminate a plan and to distribute plan balances (after 2008) in liquidation of the plan. After 2008, however, this transitional relief is not expected to be available, and the final regulations severely restrict any accelerated termination and liquidation of a plan by an employer.

Generally, discounted stock options and stock appreciation rights (collectively "stock rights") may be replaced through December 31, 2008, with non-discounted stock rights, except with respect to stock rights granted to certain executives of corporations with publicly traded stock in situations where the related financial expense was misstated on financial statements.

What Must Be Done In 2008

We recommend that every employer compile a list of all company equity, incentive and retirement plans, employment agreements, severance arrangements, and other deferral arrangements potentially subject to §409A. Such plans should be reviewed this year, if not already reviewed, to determine if they comply with the safe harbors and other provisions of §409A. If not in compliance, appropriate amendments should be made this year.

Common points of concern include:

1. Impermissible elections to defer, accelerate, or otherwise change the manner of payment.

2. Noncompliant definitions of "good reason" as a reason for termination.

3. Failure of a plan to specify, where required, a six-month delay in post-separation payments to "specified employees" of corporations with publicly traded stock."

4. Provisions in an employment agreement or other arrangement that provide for payout of the same benefit in different time or manner, depending on reason for separation from service.

5. Failure to adopt or apply a definition of "separation from service" that is consistent with the final regulations.

6. Failure to appropriately specify or apply timing requirements and limitations with respect to the reimbursement of expenses and in-kind benefits.

7. Failure to designate the time of payment for annual bonuses and other short-term incentives.

Establish Procedures To Insure Future Compliance With §409A

Consideration should be given to establishing schedules for the periodic review of all deferred compensation plans, arrangements etc. to confirm that they are being maintained and operated in accordance with §409A, taking into account the final regulations and other guidance from Treasury and the IRS.

Review processes should be established for any extension, amendment, or other modification of an existing plan, and for the exercise of administrative discretion under plans. All such extensions, amendments etc. should be reviewed by someone within the organization (or an outside advisor) who is familiar with §409A requirements. Also, procedures should be in place to ensure that key determinations under plans, such as with respect to determining who is a "specified employee" and when a "separation from service" occurs, are being made on a consistent basis.

Procedures should also be established relating to the negotiation of employment and severance arrangements. In particular, all such proposed arrangements should be reviewed from a §409A perspective before a written employment or separation agreement is executed, and ideally before it is circulated even in draft form by the employer to the prospective, current, or former employee.

Finally, appropriate steps should be taken to maintain necessary coordination between (i) revised plans, (ii) compliance with income tax and FICA withholding requirements, and (iii) tax reporting requirements (including Form W-2 and other information returns).

Correction of Operational Failures That Occur After 2008

Relief for operational failures only. Notice 2007-100 was issued by the IRS near the end of last year to provide initial guidance with regard to correcting certain failures to operate plans in accordance with §409A. For example, specified relief is provided for certain failures that are identified and corrected before the end of the year in which they arise. The notice does not address failure to meet documentation requirements of §409A, such as the requirement to have a written plan compliant with §409A.

Other programs under consideration. Notice 2007-100 also notes that the Treasury Department and the IRS are considering other corrections programs to address operational failures not within the scope of Notice 2007-100, for example where a correction is not made within the same year and the amounts involved are larger than a specified amount. The notice states that it is expected that relief would not be available if the employer failed to make reasonable efforts to comply with the terms of the relevant plan, had not established practices and procedures reasonably designed to ensure compliance with §409A, or failed to take commercially reasonable steps to avoid recurrence of similar operational failures; or where operational failure was "egregious, intentional, or . . . related to participation in an abusive tax avoidance transaction."

Conclusion

The passage of time since the enactment of §409A in 2004 has tended to cause efforts to comply to be placed on the back burner by many employers. Every effort should be made to resolve this year any plan documentation issues not already resolved, and to implement procedures to ensure full compliance by year-end with the provisions of §409A.

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