To Our Clients and Friends *September 21, 2006*

New Provision May Restrict Funding of Rabbi Trusts

The recently enacted Pension Protection Act of 2006 (the "Act") added to Section 409A of the Internal Revenue Code a provision that is intended to restrict an employer's ability to fund nonqualified deferred compensation arrangements for certain senior executives. Specifically, executives who are "covered employees" will be subject to tax (and tax penalties) currently on amounts transferred by the employer to a trust, such as a so-called "rabbi trust," for the purpose of paying deferred compensation to the covered employees if, at the time of the transfer, the employer has a tax-qualified defined benefit plan (the "qualified plan") that is significantly underfunded.

Covered employees. For purposes of the new provision, a "covered employee" includes the chief executive officer and the four most highly compensated senior executives (other than the CEO) whose compensation is potentially subject to the $1 million limitation on deductibility imposed by Code Section 162(m). Any individual subject to the short-swing profit rules of Section 16 of the Securities Exchange Act of 1934 may also be a covered employee for these purposes. An individual who was a covered employee at the time of termination of employment may remain a covered employee for this purpose, even if no longer employed at the time of the transfer.

Because of the manner in which the new Section 409A provision defines the term "covered employee," the application of the new provision should be limited to publicly held corporations.

Covered transfers. The new provision will generally apply if, at the time of the transfer, any of the following circumstances is present: (i) the underfunded qualified plan is in "at-risk" status; (ii) the plan sponsor of a qualified plan is in bankruptcy; or (iii) the transfer occurs within a twelve-month period beginning six months before the termination of a qualified plan if, as of the termination date, the assets of the qualified plan are not sufficient to provide for the payment of benefit liabilities.

The new provision may also apply, without any actual transfer or other set-aside of assets, if the nonqualified deferred compensation arrangement provides that assets will be dedicated to the provision of benefits under the arrangement in connection with any of the circumstances described in the preceding paragraph.

"At-risk" status. In general, for plan years after 2010, a qualified plan is considered to be in at-risk status if it is less than 80% funded. More lenient funding percentages apply with respect to plan years beginning in 2008 (65%), 2009 (70%), and 2010 (75%). It is important to note that the at-risk standard is not applicable to any plan year beginning before 2008.

Application of provision to controlled groups. A "controlled group" standard, as generally determined under an 80% ownership test, applies for various purposes under the new provision. Thus, for example, if a lower tier subsidiary maintains a qualified plan that is in at-risk status, the new provision may apply to a transfer to a rabbi trust under a nonqualified deferred compensation plan maintained by the parent or any other member of the controlled group.

Consequences. If assets are set aside, reserved, or transferred to a trust in a manner that is subject to the new provision, the current value of the assets is included in the covered employee's taxable income as compensation. Moreover, the special 20% tax and interest charge imposed by Section 409A with respect to deferred compensation arrangements that do not comply with the requirements of that section will generally apply in this context as well.

The additional 20% tax and an interest charge will also generally apply with respect to any "gross-up" payment by an employer of income taxes that are imposed with respect to any compensation required to be included in an employee's gross income by reason of this new restriction on funding. Finally, no deduction will be allowed to the employer on account of such gross-up payments.

Effective date. The new provision is generally applicable to any funding of a nonqualified plan after August 17, 2006.

Next Steps: Plan Amendments

In light of this new provision restricting the funding of nonqualified plans, potentially affected employers must consider amendments to plans and trust agreements with respect to existing nonqualified deferred compensation arrangements that may be necessary to avoid triggering the onerous tax consequences imposed by the new provision.

Deadline for certain plan amendments. Employers (whether publicly held or otherwise) maintaining nonqualified deferred compensation arrangements should keep in mind the scheduled expiration at year-end of important IRS transitional rules under Section 409A. These rules provide flexibility (a) to amend nonqualified deferred compensation arrangements to bring them into compliance with Section 409A on or before December 31, 2006, (b) to make new payment elections (with respect to previously deferred compensation) on or before that date, and (c) to permit employers to replace on or before that date stock options and stock appreciation rights that are not compliant with the requirements of Section 409A (e.g., by reason of a built-in discount at the time of grant) with stock options and SARs that do comply with those requirements. Although the deadline may be extended further, employers that have or may have equity incentive or other deferred compensation arrangements that have not yet been conformed to the requirements of Section 409A (and that are not otherwise grandfathered under the effective date rules of that section) should take appropriate action to identify and rectify these problems before year-end.

If you have any questions or would like further information regarding the matters discussed above, please call Norman J. Misher at (212) 903-8733, David E. Kahen at (212) 903-8763, or Allen J. Erreich at (212) 903-8769.

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