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COUNTDOWN TO COMPLIANCE

Are You Ready for the Section 409A Compliance Deadline?

All nonqualified deferred compensation arrangements must satisfy, or be exempt from, the requirements of Section 409A of the Internal Revenue Code by **December 31, 2008**.

Background

Section 409A of the Internal Revenue Code was enacted in 2004 to limit favorable income tax treatment of nonqualified deferred compensation to arrangements that meet specified design and operational requirements.

The rules include: restrictions on deferral elections and changes to elections, limitations on the time and form of payments (only six permissible payment events), a prohibition on accelerated payments, restrictions on funding, and requirements for tax reporting and withholding.

Since 2004, the Internal Revenue Service has issued regulations, several notices, and other guidance providing transition relief to assist companies in bringing compensation arrangements into compliance with Section 409A. The transition relief period ends on December 31, 2008.

Failure to Comply

If an arrangement subject to Section 409A fails to comply with its requirements, the employee or other service provider (e.g., director, independent contractor, or consultant) will be subject to:

- accelerated taxation of the noncompliant compensation *and all of the same type of compensation* (even if no payments are received);
- an additional 20% federal income tax on the compensation amount; plus
- interest at the underpayment rate plus 1%.

Broad Coverage

Many companies have been surprised to learn how broad the definition of a nonqualified deferred compensation plan is for purposes of Section 409A.

Below are some examples of common arrangements that may include a deferral of compensation subject to the requirements of Section 409A:

- Offer letters
- Employment agreements
- Severance arrangements
- Consulting agreements
- Change in control agreements
- Long-term incentive plans
- Bonus awards
- Performance plans
- Stock options/stock appreciation rights
- Restricted stock units
- Phantom equity awards
- Director fee deferrals
- Deferred compensation plans
- 401(k) mirror or make-up plans
- Section 457(f) plans
- Any other deferral of compensation

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A plan or agreement generally provides for the deferral of compensation if the employee (or other service provider) has a legally binding right during one tax year to compensation that is, or “may be,” payable to the individual in a later tax year.

Helpful Exceptions

Although the coverage of Section 409A is very broad, there are some helpful exceptions that may apply to certain arrangements (e.g., short-term deferrals, involuntary separation pay plans, non-discounted stock options, and stock appreciation rights).

In many cases the exception will not be available unless the arrangement is amended by December 31, 2008 to comply with the requirements for the exception.

Problem Areas

Section 409A includes numerous technical requirements that apply to “standard” compensation arrangements. Some of the common issues raised by Section 409A include:

- How do the rules apply to arrangements entered into before January 1, 2005?
- When does the required 6-month delay in payment for specified employees apply?
- Who is a specified employee?
- When has an individual “separated from service” under Section 409A?
- When is a separation from service “involuntary”?
- How is “fair market value” of stock determined for private company stock options?
- What are the permissible payment events under Section 409A?
- When can an agreement include more than one payment event or form of payment?
- How do the rules apply to continued medical coverage and reimbursement arrangements?
- What restrictions apply to a plan termination?
- What changes can be made to the plan or agreement after December 31, 2008?

Planning Opportunity – Last Chance to Change

The transition relief period provided by the government includes one “last chance” to make certain changes to payment elections and other plan design. After December 31, 2008, any changes must comply with the restrictive requirements for changes under Section 409A (e.g., changes to payment elections are only available to delay a payment for at least five years from the original payment due date).

Plan Document Compliance

Section 409A requires both “operational” and “plan document” compliance. All compensation arrangements have been subject to “good faith” operational compliance since 2005. As of **December 31, 2008**, all arrangements must be brought into compliance with the plan document requirements.

The plan document requirement provides that all material terms of the deferred compensation arrangement must be in writing. The material terms include:

- who is covered;
- the amount of compensation to be paid;
- the time of payment; and
- the form of payment.

Where applicable, the plan or agreement must provide for the six-month delay in payment (for any payment to a specified employee of a publicly traded company triggered by a separation from service).

Beginning **January 1, 2009**, both operational and plan document compliance will be determined by compliance with the Section 409A final regulations (issued April 10, 2007). In some cases, the final regulations are significantly different than the transition relief guidance. Now is the time to identify what changes apply to your compensation arrangements.

All Approvals and Signatures

Plans must be operated in compliance with Section 409A throughout the transition period. All amendments to conform to the technical requirements of Section 409A and the final regulations must be completed by **December 31, 2008**.

In some cases, the changes to existing arrangements may require negotiation with service providers and board or compensation committee approvals. If the company is subject to SEC reporting requirements, Form 8-K, Form 10-K, Form 10-Q, Form S-8, and proxy statement disclosures may be necessary.

Now is the time to review the status of your compliance efforts and to make any necessary changes to ensure that all amendments or new agreements and plans will be completed prior to December 31, 2008. In addition, you should implement or revise your compliance procedures to avoid any operational noncompliance with the rigorous requirements of the final regulations under Section 409A.

If you have any questions concerning this alert, Section 409A, or other compensation and benefits matters, please contact any of the attorneys listed on the first page of this alert.

This alert was not intended or written to be used, and cannot be used, for the purpose of avoiding the tax-related penalties under federal, state, or local tax law.

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