

CODE SECTION 409A FINAL REGULATIONS ON DEFERRED COMPENSATION

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On April 10th, 2007 the IRS issued its long-awaited final regulations under Code Section 409A. Code Section 409A imposes strict requirements on nonqualified deferred compensation (NQDC) plans. These requirements have been in effect since the beginning of 2005, and we've already taken preliminary steps to comply with them. However, IRS postponed the deadline for full compliance until the end of 2007, while it worked on finalizing the proposed regulations that were issued in 2005.

The final regulations that IRS has now issued are generally similar to the proposed regulations, but include significant new provisions that make compliance easier. The final regulations will take effect on Jan. 1, 2008, but can be relied on before then. Now that the final regulations are available, prompt action must be taken to amend any of your plans that don't comply with them, because no extension beyond Dec. 31, 2007 is expected.

The costs of noncompliance are high. All amounts deferred under a noncompliant NQDC plan are included in the employee's income. Interest is also imposed on that income at a rate one percentage point higher than the interest rate on tax underpayments. On top of that, a 20% penalty is imposed. While these sanctions fall on the employee, their impact will be felt by the employer, either through a formal indemnification agreement or through employee dissatisfaction.

Certain plans enjoy an exemption from the Code Section 409A requirements. Qualified retirement plans, tax-deferred annuities, simplified employee pensions (SEPs), and SIMPLE retirement accounts aren't considered NQDC plans. Code Section 409A also doesn't apply to some welfare benefit plans, such as bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.

There's also an exception for short-term deferrals. Under this rule, there's no deferral of compensation if the employee receives the compensation by 2 1/2 months after the end of the tax year of the employer or employee, whichever is later, in which the amount is no longer subject to a substantial risk of forfeiture.

Nonstatutory stock options (NSOs) and stock appreciation rights (SARs) on employer stock don't provide for deferral of compensation if the option or SAR isn't "in the money" on the date of grant and there's no other feature for deferral of compensation. The final regulations provide a liberalized definition of stock that may be used for this purpose, and provide rules for determining the fair market value of the stock. The final regulations also allow longer extensions of the exercise period of stock options and SARs.

If it's determined that Code Section 409A applies to a plan, the next step is to make sure that the plan complies with the Code Section 409A requirements. There are four general requirements that relate to: (1) the initial deferral election, (2) the timing of payments, (3) acceleration of payments, and (4) later deferral elections. Each of these requirements must be spelled out in the plan document, and the plan must be operated in accordance with them.

Code Section 409A generally applies for: (1) amounts deferred in tax years beginning after 2004; and (2) amounts deferred in tax years beginning before 2005 if the NQDC plan is materially modified after Oct. 3, 2004. However, IRS has given taxpayers until the end of 2007 to amend plan documents to comply with Code Section 409A and the final regulations.

In the time that remains before the final regulations take effect, we must finalize any changes to your deferred compensation plans that are required to comply with Code Section 409A and make sure that those changes are properly reflected in the plan documents. We must also make sure that the plans will be operated in accordance with the Code Section 409A requirements. Finally, we must obtain any new payment elections from plan participants that are permitted under the transitional rules.

Please ask a member of our business or tax department to review your deferred compensation arrangements and ensure they comply with Code Section 409A.