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MEMBERS OF THE EMPLOYEE BENEFITS GROUP

Mark B. Klein, Chair
mklein@dilworthlaw.com

John W. Schmehl
jschmehl@dilworthlaw.com

Matthew I. Whitehorn
mwhitehorn@dilworthlaw.com

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3200 Mellon Bank Center
1735 Market Street
Philadelphia, PA 19103
P: 215.575.7000
F: 215.575.7200

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SECTION 409A UPDATE: NON-QUALIFIED DEFERRED COMPENSATION

By: Matthew I. Whitehorn, Esquire

Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), was implemented by the American Jobs Creation Act of 2004 (P.L. 108-357). For purposes of Section 409A, non-qualified deferred compensation can exist in many different forms, whether in a traditional plan document, employment agreement or severance program. Generally, under these types of plans, there is no inclusion of deferred amounts in income until a "substantial risk of forfeiture" lapses, for example, requiring employment on a date certain as a condition to payment.

Section 409A ("409A") resulted from the Enron problem, when corporate insiders with non-qualified deferred compensation plans received preferential distributions of company assets to the detriment of shareholders and creditors. Final Treasury regulations underlying 409A, which were preceded by several notices as well as proposed regulations, were issued on April 10, 2007. The final regulations are considered very complex. As a result, lawyers' groups and business lobbyists have successfully requested effective date delays from the Internal Revenue Service ("IRS") and Treasury Department.

Payment Events

In order to prevent abuses, the final regulations limit 409A-compliant permissible payment events to:

- death
- disability (as defined under 409A)
- separation from service
- certain changes in corporate control
- unforeseeable emergency
- those in accordance with a specified time or a fixed schedule that is set at the date of deferral

Under 409A, payments cannot be triggered based on a company's financial health. In addition, acceleration of payments is generally prohibited, with limited exceptions. Extensions or other modifications of the time or form of scheduled payment dates is also generally prohibited, except where such a date is pushed back for five years from the originally scheduled date and the extension election is made at least one year in advance of the originally scheduled date. Furthermore, payments to certain key officers who are "specified employees" of corporations with publicly-traded stock must be delayed for six months following the date of separation from

service. In any event, a written plan document is required under 409A that specifies timing and payment provisions that are 409A-compliant.

Covered Arrangements

409A applies not only to traditional nonqualified deferred compensation plans, such as "top hat" plans or rabbi trusts for executives, but can also apply to employment agreements, performance bonus programs, separation pay, discounted equity and stock plans (*e.g.*, discounted options and stock appreciation rights ("SARs")) and a gamut of other compensation-related programs. Deferred compensation, for 409A purposes, exists where there is a binding right to receive compensation for services performed during a given year in a later year.

Importantly, there are several exceptions from 409A coverage. The principal one is known as the "short-term" deferral rule. Basically, if deferred compensation is paid out no later than 2-1/2 months following the year during which it vests (by March 15th in the case of a calendar year employer), the payment is not treated as deferred compensation for 409A purposes.

Another crucial exception from 409A coverage is for certain separation pay arrangements. Generally, the "two-times/two-years" rule states that involuntary separation pay that does not exceed two times the compensation limit for qualified retirement plans, that is, a maximum of $450,000 for 2007 ($460,000 for 2008) and is paid out no later than the end of the second year after termination of employment, is exempt from 409A coverage. Under certain conditions, voluntary "good reason" terminations are treated as involuntary for purposes of invoking the separation pay exemption.

Additionally, certain deferred compensation arrangements that were in place on October 3, 2004, are treated as "grandfathered" and are exempt from 409A, unless their terms are materially modified after that date.

Timing of Deferral Elections

Under 409A, deferral elections must be effectuated no later than the last day of the year preceding the year in which covered services are to be performed. For example, an employee's election to defer compensation for services performed in 2008 must be in place by December 31, 2007. There is a special 30-day election for newly eligible participants.

Substantial Risk of Forfeiture

409A does not recognize a covenant of noncompetition as constituting a valid substantial risk of forfeiture. 409A also rejects the concept of extension of a vesting date, commonly known as a "rolling risk of forfeiture."

Tax Implications of 409A Non-Compliance

When a deferred compensation plan violates 409A, rather onerous negative tax consequences result for the employee:

- the immediate inclusion of the deferred amount in income
- an additional 20% penalty (*i.e.,* 20% of the amount included in income)
- the imposition of deemed interest

Effective Date

Under the final regulations, written documents were required to be 409A-compliant by December 31, 2007. However, IRS Notice 2007-78 (issued on September 10, 2007) extended the written compliance documentation deadline date until December 31, 2007. More recently, IRS Notice 2007-86 (issued on October 22, 2007) again further extended that deadline until December 31, 2008. In addition, the transitional relief period to make changes to existing time and form of payment elections without violation of the 409A anti-acceleration and impermissible payment date extension rules is now extended until December 31, 2008. (However, new payment elections cannot be made in 2008 to defer payments otherwise payable in 2008.) In any event, operational compliance with 409A is required as of January 1, 2008. Reliance on the final regulations is treated as a reasonable, good faith interpretation of the statute.

457(f) Plans

On July 23, 2007, the IRS released Notice 2007-62, which previews the anticipated final guidance on 457(f) plans.

Under an "ineligible" 457(f) plan sponsored by a tax-exempt organization, deferred compensation is includable in income, or vests, when the substantial risk of forfeiture lapses (for example, an employee who must continue to remain employed until a specific date in order to receive payment has a taxable event on the date when that condition is satisfied). It appears that the IRS does not intend to recognize a rolling risk of forfeiture as a permissible extension of a vesting date, and in the view of some, may not even recognize the 5-year pushback rule under 409A for 457(f) purposes. In addition, a covenant not to compete would also not constitute a substantial risk of forfeiture under Notice 2007-62. Notice 2007-62 indicates that its guidance is meant to be prospective only, but that taxpayers may rely on its rules concerning substantial risk of forfeiture pending the release of final guidance. It would seem likely that the IRS would offer some transitional relief for existing 457(f) plans.

What to Do Now?

It would be a prudent measure to have counsel initiate the process of reviewing any existing deferred compensation agreements, employment agreements and severance programs for 409A compliance. While the urgency of such measures has been reduced by the December 31, 2008 deadline extension, this process may yet prove to be a very time-consuming task. The IRS recently released its 409A correction program (Notice 2007-100 [December 3, 2007]), apparently, in recognition of the complexity of these rules.

Mr. Whitehorn is a member of Dilworth Paxson's Employee Benefits Group. He works with clients on a broad range of benefits issues as well as also services retirement/401(k), 403(b), 457(b), and executive compensation programs through select investment advisory and professional services firms with Professional Capital Services, LLC, a Dilworth-affiliated third-party administration and recordkeeping firm. He can be reached at (215) 575-7166 or mwhitehorn @dilworthlaw.com.