Fox Rothschild LLP
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EMPLOYEE BENEFITS & COMPENSATION PLANNING GROUP

ALERT

Deferred Compensation Law Requires Immediate Action

Over the course of the past three years, Fox Rothschild has advised our clients and colleagues regarding the regulation of deferred compensation by Internal Revenue Code Section 409A. Full implementation was delayed while regulations were formulated, but now the compliance deadline approaches. If you have not already done so, you may need to take *immediate* action to assure that all deferred compensation plans or programs that you sponsor, or in which you participate, comply with Section 409A of the Internal Revenue Code.

What is Section 409A?

Added to the Internal Revenue Code by the American Jobs Creation Act of 2004 in reaction (or perhaps, over-reaction) to the corporate excesses and perceived abuses of Enron, WorldCom, Tyco, and others, Section 409A is intended to curb the ability of executives to manipulate their own compensation to the detriment of employees and corporate shareholders. In a nutshell, this very complex law requires that each deferred compensation plan or arrangement comply, both in form and in operation, with detailed and rigid qualification requirements.

What is "Deferred Compensation"?

Under 409A, any compensation to be paid in any tax year after the year in which the services were performed may be deferred compensation. The deferral occurs when the employee first obtains a legally binding right to payment, even if that right is conditional or contingent.

The 409A regulations take an extremely broad view of what constitutes deferred compensation and make clear that "deferred compensation" under 409A encompasses not only traditional deferred compensation plans (pursuant to which an executive elects to defer receipt of some portion of his/her salary or bonus) but also payments under severance agreements, employment contracts, and non-elective plans. Exempted from Section 409A are most tax-qualified retirement plans, IRAs, 457(b) plans, and bona fide vacation, sick leave, compensatory time, disability pay, and death benefit plans. Likewise, certain foreign plans, short-term deferral arrangements, and plans that provide for severance pay upon involuntary severance from employment are deemed to satisfy the requirements of 409A.

What does Section 409A require?

Section 409A (as augmented by hundreds of pages of regulations) dictates when an election to defer must be made, when compensation that has been deferred may be distributed, and when and how a participant may elect to further extend the deferral period. Each deferred compensation plan or arrangement must satisfy the requirements of Section 409A both in form (i.e., the documents must comply) and in operation (i.e., actual compliance with 409A is required in determining eligibility and benefits).

Each deferred compensation plan or arrangement, in its written form, must be amended to comply effective

January 1, 2009. In addition, each plan or arrangement must be operated in "good faith" compliance with 409A for deferrals made on or after *January 1, 2005*. Specific requirements as to form and operational compliance vary depending upon the type of deferred compensation plan involved.

What happens in the event of failure to satisfy 409A?

Failure to satisfy 409A either in form or in operation may result in substantial adverse tax consequences to the employee, including:

1	immediate taxation of all amounts deferred under the plan
2	assessment of interest at one percent above the IRS rate for underpayment of tax with respect to the deferral period
3	an additional 20 percent penalty tax

There are consequences for the employer, too, including additional tax reporting and withholding obligations and potentially thorny employee relations issues.

What is the deadline?

By December 31, 2008, every deferred compensation plan or arrangement must be amended to assure compliance with the requirements of 409A, in form, effective as of January 1, 2009. Further, the employer must ensure "good faith" operational compliance for 2008. Given the complexity of the law, precious little time remains!

Immediate Action Items

First, make an inventory of all plans, arrangements, agreements, and/or contracts that provide (or might be deemed to provide) for the deferral of compensation. Among the arrangements to which 409A can apply are:

- employment agreements
- bonus plans and practices
- excess benefit plans or supplemental employee retirement plans (SERPs) that provide benefits above qualified plan limits
- severance plans and practices
- executive retention and/or change in control agreements
- equity compensation plans, including stock appreciation rights, phantom stock unit and "in the money" option plans
- certain COBRA continuation arrangements
- expense reimbursement policies
- deferral arrangements described in employee handbooks or manuals

Fox Rothschild can assist in amending your programs to the extent necessary and will work with you on practical assessments of your operational "good faith" compliance with 409A. As always, we stand ready, willing, and able to assist you in any way you deem appropriate.

Please contact co-chairs Susan Foreman Jordan at 412.394.5543 or sjordan@foxrothschild.com, or Harvey M. Katz at 212.878.7976 or hkatz@foxrothschild.com, or any member of the Employee Benefits & Compensation Planning Group to determine which plans or arrangements are covered. View our contact list here: http://www.foxrothschild.com/PracticeAreas/Employee_Benefits_and_Compensation_Planning/Attorneys.aspx, or visit us on the Web at www.foxrothschild.com.

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