PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the Firm

September 2008

Deadline for Compliance with Internal Revenue Code Section 409A Is Approaching

Internal Revenue Code Section 409A ("Code Section 409A") places significant limitations on the flexibility of "deferred compensation" arrangements. The final regulations under Code Section 409A were issued in April 2007 and will become fully effective on January 1, 2009. Operational compliance with Code Section 409A is necessary, but until the end of 2008, we are in a "transition period" that permits good faith administration and allows employers to amend their plans, agreements and practices as necessary to comply with the requirements of Code Section 409A. Full documentary and operational compliance is necessary starting January 1, 2009.

Every traditional deferred compensation plan, employment agreement, severance arrangement, and equity plan must be reviewed and most likely amended by December 31, 2008.

The penalty for noncompliance with the applicable requirements of Code Section 409A applies to the employee (not the employer) and includes immediate taxation of amounts intended to be deferred, as well as an additional 20 percent tax on noncomplying deferred compensation. However, an employer is responsible for properly withholding applicable taxes and will have tax reporting obligations. **A more detailed explanation of the final regulations may be found in our April 2007 Client Alert, which is available on our Website at http://www.proskauer.com/news_publications/client_alerts/content/2007_04_30.**

The most difficult part of Code Section 409A is that it not only applies to what are normally considered traditional deferred compensation arrangements, but also to arrangements not traditionally viewed as deferred compensation. Such arrangements include severance arrangements, employment or separation agreements, certain equity arrangements, and split-dollar life insurance arrangements (as further discussed below). Code Section 409A does not apply to tax-qualified pension plans or Section 403(b) plans, but it does apply to nonqualified pension arrangements.

The **first** step in complying with Code Section 409A on a timely basis is to identify all arrangements potentially subject to the requirements of Code Section 409A and to obtain copies of all applicable documentation.

The arrangements that potentially are subject to Code Section 409A include:

- All employment agreements.
- All severance or termination agreements and severance plans, arrangements, or practices.
- Every deferred compensation plan (taken broadly, any arrangement that involves amounts or benefits earned in one year and paid in a future year—many of these may be exempt because of what is known as a "short-term deferral" or due to one of the other exemptions, but they should still be reviewed). As noted above, any tax-qualified pension plan or 403(b) plan is exempt, but nonqualified pension benefit plans (including SERPs and supplemental savings plans) are subject to Code Section 409A.
- Any post-employment reimbursement plan or payment plan.
- Any post-employment consulting arrangement.

- Any termination-oriented sabbatical or leave arrangements.
- All equity plans and grants.
- Foreign based compensation arrangements that include U.S. taxpayers.
- Fringe benefits, expense reimbursements and similar arrangements.

The **second** step is to review each arrangement that is potentially subject to Code Section 409A to determine if it is in compliance and what steps, if any, are necessary to ensure compliance. In most cases, required changes will be limited and will likely consist of including specific provisions regarding the timing and form of the payment of compensation in order to avoid employer or employee discretion. In addition, with respect to certain deferred compensation payments made upon termination of employment to specified officers and other key employees of public companies, Code Section 409A also imposes a six-month delay on such payments (which must be specifically reflected in the documents governing such arrangements). A critical component of addressing the Code Section 409A consequences of employment agreements and other contractual arrangements involves obtaining employee consent to the Code Section 409A amendments. If there are any unwritten arrangements that are subject to Code Section 409A, such arrangements must be in writing by December 31, 2008.

The **third** and **final** step is to evaluate operational procedures, focusing on and ensuring that payroll and other operating procedures satisfy the requirements of Code Section 409A on an ongoing basis.

We strongly encourage you to act now in implementing a Code Section 409A review procedure to allow for adequate time to review all arrangements subject to Code Section 409A, evaluate compliance alternatives and prepare amendments as necessary. Advance planning is recommended as amending arrangements that are subject to Code Section 409A may require approval from the board of directors or compensation committee and/or employee consent.

We would be glad to assist you in reviewing these arrangements.

You can also visit our Website at **www.proskauer.com**

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