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WITH THE DEFERRED COMPENSATION AMENDMENT DEADLINE APPROACHING, NOT-FOR-PROFIT PROVIDERS SHOULD DO A SELF-AUDIT OF THEIR DEFERRED COMPENSATION ARRANGEMENTS

The regulations for the nonqualified deferred compensation requirements under Section 409A of the Internal Revenue Code ("Code") are expected to be finalized later this year, and it is anticipated that those regulations will require employers to amend their nonqualified deferred compensation arrangements ("Deferred Compensation Arrangements") within a relatively short period of time after the issuance of those regulations. In order to ensure that they are prepared for this amendment deadline, not-for-profit health care providers should do a self-audit of their Deferred Compensation Arrangements. A self-audit will not only help identify which Deferred Compensation Arrangements may need to be amended to comply with those regulations, but also whether the organization is in compliance with (1) the restrictive tax requirements for nonqualified deferred compensation arrangements under Section 457 of the Code and (2) applicable requirements under the Employee Retirement Income Security Act ("ERISA").

The definition of a nonqualified deferred compensation arrangement is much broader than many not-for-profit organizations realize (e.g., it could include employment agreements, leave arrangements and separation arrangements that provide for payments in a future calendar year). A failure to properly structure these arrangements could result in serious adverse tax consequences and ERISA penalties.

Structuring a Self-Audit of Deferred Compensation Arrangements

A self-audit of an organization's Deferred Compensation Arrangements should be structured to cover compliance with at least the following:

- the nonqualified deferred compensation requirements of Section 409A of the Code;
- the tax requirements of Section 457 of the Code;
- other tax obligations applicable to Deferred Compensation Arrangements; and
- the employee benefit requirements of ERISA, to the extent applicable.

Compliance With the Nonqualified Deferred Compensation Requirements Under Section 409A of the Code

Not-for-profit organizations should identify all Deferred Compensation Arrangements that are subject to the nonqualified deferred compensation requirements under Section 409A of the Code, and review what steps may need to be taken to ensure compliance with those requirements. Requirements include new deferral election rules, payment election requirements, distribution restrictions, funding requirements, and reporting obligations.

A "nonqualified deferred compensation plan" is broadly defined under Section 409A of the Code as any plan, agreement or arrangement that provides for the deferral of compensation. This definition is broad enough to include arrangements that are not often thought of as being a nonqualified deferred compensation plan, such as certain employment agreement provisions, severance pay plans, and split-dollar life insurance arrangements. The definition also is broad enough to include arrangements for one person, and arrangements for directors and independent contractors. Excluded from this definition are certain retirement plans

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(e.g., tax-sheltered annuity plans under Section 403(b) of the Code and qualified retirement plans under Section 401(a) of the Code), eligible deferred compensation plans under Section 457(b) of the Code, and certain welfare benefit plans (e.g., bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans).

Many Deferred Compensation Arrangements will require amendments to comply with these requirements. Depending upon when the regulations under Section 409A of the Code are finalized, these amendments could be required in 2007 (the Internal Revenue Service is expected to announce the final amendment deadline after the regulations are finalized).

Satisfaction of the Tax Requirements of Section 457 of the Code

Not-for-profit organizations should analyze their Deferred Compensation Arrangements to ensure that such Arrangements comply with the restrictive tax requirements of Section 457 of the Code. Section 457(f) generally provides that in order to defer an employee's compensation to a future calendar year, the payment of that compensation must be contingent on the employee performing substantial services for the employer through a date in that future calendar year. If such a contingency is not present, the compensation will be taxed in the first calendar year in which that contingency is no longer present (e.g., if an organization establishes a Deferred Compensation Arrangement that provides an employee with $20,000 a year for the following two calendar years, the employee generally will be taxed on the $40,000 in the calendar year that the arrangement is established if the payment of that $40,000 is not contingent on the employee performing substantial services for the organization in the two future calendar years). Certain arrangements are exempt from the substantial services requirement in Section 457(f), including eligible deferred compensation plans under Section 457(b), tax-sheltered annuity plans under Section 403(b), and qualified retirement plans under Section 401(a).

Not-for-profit organizations should identify all of their arrangements that provide for a deferral of compensation to a future calendar year, including any arrangements that are part of paid leaves, employment agreements, separation agreements, and settlement agreements. These arrangements should be analyzed to see if they satisfy the substantial services requirement in Section 457(f) (assuming one of the exceptions to that requirement does not apply). Of particular concern are arrangements by which an organization agrees to provide compensation in a future calendar year without requiring the covered person to perform substantial services in that future year (e.g., a leave arrangement or a separation arrangement that provides payments over a two year period, with no requirement that substantial services be performed in the second year). If not properly structured, such an arrangement could result in the covered person being taxed on all of the deferred compensation in the calendar year the arrangement is entered into (which would put the person in the difficult position of owing taxes on deferred compensation that will not be paid until a future calendar year).

Compliance With Other Tax Obligations

Deferred Compensation Arrangements also should be reviewed for compliance with other tax obligations, including the following (to the extent applicable): (1) satisfaction of the excess benefit transaction requirements under Section 4958 of the Code (they require, among other things, that benefit arrangements for certain employees be "reasonable"); (2) compliance with the Federal Insurance Contribution Act ("FICA") tax withholding requirements under Section 3121(v) of the Code; and (3) satisfaction of the Form 990 reporting requirements for certain persons who receive deferred compensation benefits. Certain governmental institutions are exempt from these requirements.

Satisfaction of the Employee Benefit Requirements of ERISA

If a plan maintained by a not-for-profit health care provider is subject to ERISA, each Deferred Compensation Arrangement must be structured to comply with ERISA's employee benefit requirements. This means, among other things, that a not-for-profit corporation generally should (1) structure each such Deferred Compensation Arrangement as a "top hat pension plan" (which is defined by ERISA as an unfunded plan that is maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees), and (2) make a proper "top hat pension plan" filing with the United States Department of Labor ("DOL") within 120 days after each Deferred Compensation Arrangement is established. Failure to do either of these could trigger onerous ERISA administrative requirements and/or significant ERISA penalties.

An exemption from ERISA exists for certain church plans and governmental plans.

Correction of Violations, and Establishing Procedures To Avoid Future Violations

If a self-audit reveals any Code or ERISA violations with respect to a Deferred Compensation Arrangement, those violations should be corrected. Not-for-profit organizations also should consider establishing procedures that will help avoid Code and ERISA violations arising with respect to future Deferred Compensation Arrangements.

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