



Electronic Dispatch

Employee Benefits Law Action Memo

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IMMEDIATE ACTION REQUIRED TO ENSURE COMPLIANCE WITH THE DECEMBER 31, 2007 AMENDMENT DEADLINE IN THE NEW FINAL DEFERRED COMPENSATION REGULATIONS

On April 10, 2007, the Internal Revenue Service ("IRS") issued 397 pages of final regulations (including the preamble) for nonqualified deferred compensation arrangements under Section 409A of the Internal Revenue Code ("Regulations"). The Regulations provide, among other things, that any plan amendments that are needed to ensure compliance with the Regulations must be made no later than December 31, 2007. IRS officials have stated several times that this amendment deadline will not be extended.

The scope of these nonqualified deferred compensation requirements is very broad, and includes not only "traditional" deferred compensation agreements and plans but also a wide variety of other compensation arrangements where an employee, an independent contractor, or a member of a Board of Directors or a Board of Trustees has a legally binding right to compensation that will be paid in a later tax year. Employers should immediately review all of their existing written and unwritten compensation arrangements that provide for a deferral of compensation for such individuals (including, but not limited to, any such arrangements that are in existing deferred compensation agreements and plans, offer letters, employment agreements, severance pay arrangements, separation agreements, bonus plans, incentive compensation arrangements, reimbursement arrangements, supplemental benefit plans, excess benefit plans, stock appreciation rights plans, "phantom" stock plans, change-in-control arrangements, retention bonus arrangements, split-dollar life insurance arrangements, consulting agreements, director fee agreements, and other similar plans and arrangements) and determine if any amendments are needed to comply with the Regulations.

An employer should assume that an arrangement that provides for a deferral of compensation is subject to the nonqualified deferred compensation requirements of Section 409A of the Internal Revenue Code ("Code"), unless it can identify an exemption from those requirements that applies to that arrangement. There are a number of exemptions listed in the Regulations that will be helpful to employers.

What Are the Consequences If the Amendment Deadline In the Regulations Is Not Satisfied?

A failure to satisfy the amendment requirements in the Regulations could result in serious adverse tax consequences for individuals covered by the noncompliant nonqualified deferred compensation arrangement. These consequences include:

- the affected individuals having to include in gross income the current and prior deferrals that are vested;
- an interest penalty on the taxes owed on the prior deferrals; and
- a special 20 percent excise tax on the amounts required to be included in income as a result of the violation.

In certain circumstances other nonqualified deferred compensation plans may be required to be aggregated with the noncompliant nonqualified deferred compensation plan, and the same tax consequences could also apply to those other plans.

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What Are the Major Requirements Imposed On Nonqualified Deferred Compensation Arrangements By Section 409A of the Code?

Section 409A of the Code generally provides that if a nonqualified deferred compensation arrangement fails to satisfy the requirements of Section 409A, compensation deferred under that arrangement for all years will be currently includible in gross income to the extent it is not subject to a substantial risk of forfeiture and it has not previously been included in gross income. A nonqualified deferred compensation arrangement that is subject to Section 409A of the Code will be subject to the following requirements (among others):

- new deferral election rules;
- payment election requirements;
- distribution restrictions;
- funding requirements; and
- reporting obligations.

These requirements were part of legislation that was signed into law by President Bush on October 22, 2004, and those legislative requirements were summarized in an October 2004 BS&K Employee Benefits Law Action Memo (that Memo is available at our web site, <http://www.bsk.com/archives/infomemo.dbm?StoryID=503>). These requirements generally became effective for nonqualified deferred compensation amounts that (1) were earned or became vested after December 31, 2004, or (2) were deferred in tax years beginning before 2005, if the applicable nonqualified deferred compensation plan was materially modified on or after October 3, 2004. Employers and other taxpayers have been required to act in reasonable, good faith compliance with the requirements of Code Section 409A since these effective dates (based on the IRS guidance available at the applicable time), with the exception that amendments to nonqualified deferred compensation arrangements were not required until the date specified in the Regulations.

If an existing nonqualified deferred compensation arrangement that is subject to Section 409A of the Code has written terms that do not satisfy the requirements in the Regulations, the Regulations provide that those terms must be amended no later than December 31, 2007 to ensure continued compliance with the Code Section 409A requirements. The plan document requirements that apply to nonqualified deferred compensation arrangements under Section 409A of the Code are specified in the Regulations.

How Is a Nonqualified Deferred Compensation Plan Defined Under the Regulations?

A “nonqualified deferred compensation plan” is generally defined under Section 409A of the Code as any plan, agreement, or arrangement that provides for a deferral of compensation (this definition is broad enough to include an arrangement for a single employee, as well as an arrangement for independent contractors, directors, or trustees). The Regulations state that an arrangement generally provides for a deferral of compensation if an individual has a legally binding right during a taxable year to compensation that is or may be payable to the individual in a later tax year. Even if deferred compensation is subject to a contingency in a future tax year (e.g., a requirement that the individual work through a specified date in that future year in order to receive the compensation), it still could be a “nonqualified deferred compensation plan.”

After an employer or other taxpayer has identified all of its nonqualified deferred compensation plans, it must then determine whether any of the exemptions from coverage under Section 409A of the Code apply to those plans. An analysis also should be made of each provision in the nonqualified deferred compensation plan that triggers a payment (“Payment Trigger”). Each such Payment Trigger should either satisfy the requirements of Section 409A of the Code, or should itself qualify for an exemption from the Section 409A requirements.

What Are Some of the More Important Exemptions From the Requirements of Section 409A of the Code?

Among the more important exemptions from the requirements of Section 409A of the Code are:

- certain tax-favored retirement benefits (e.g., qualified retirement plans under Section 401(a) of the Code, tax-sheltered annuity plans under Section 403(b) of the Code, simplified employee pensions, SIMPLE retirement accounts, and eligible deferred compensation plans under Section 457(b) of the Code);

- certain welfare benefit plans (e.g., bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefits plans), certain nontaxable medical benefits, and certain educational benefits;
- certain short-term deferrals;
- certain separation pay plans (including certain payments upon an involuntary separation from service, certain payments made pursuant to a voluntary "window" program, certain reimbursements following an involuntary or voluntary separation from service, and certain "limited" payments in the year of separation from service);
- certain legal settlement, indemnification, and liability insurance payments;
- certain nonqualified stock options and stock appreciation rights; and
- certain independent contractor and foreign plan payments.

Why Should Immediate Action Be Taken To Comply With the December 31, 2007 Amendment Deadline?

In light of the broad scope of the requirements in the Regulations, employers and other taxpayers will need time to identify all of the nonqualified deferred compensation arrangements that will need to be amended. Decisions will then need to be made about what amendments to make to each arrangement, what approvals will need to be obtained to make such amendments (e.g., some amendments may require negotiations with employees, and some amendments may require approval by a Board of Directors or shareholders), what other documents may need to be filed (e.g., filings with the Securities and Exchange Commission), and what other documents may need to be revised (e.g., summaries of plan benefits and enrollment forms).

If you have any questions about this memorandum, please contact Ted Lewkowicz (315-218-8131, tlewkowicz@bsk.com) or any of the other members of our Employee Benefits Practice Group listed below.

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