

## Janich Law Group

### *Employee Benefits Client Alert:* *October 2008*

#### Q&A ON §409A: COMPLIANCE DEADLINE FOR DEFERRED COMPENSATION PLANS AND AGREEMENTS

##### **Q-1: Why should service providers and service recipients be concerned with Internal Revenue Code §409A at this time?**

Because all deferred compensation plans and arrangements must be amended by December 31, 2008. Appendix FAQ-2 describes the types of deferred compensation plans and arrangements covered by §409A. A failure to timely amend will result in a violation of §409A and the imposition of civil penalties upon the service provider and service recipients involved. See Appendix FAQ-3 for a detailed description of the penalties involved.

Time is running out on employers who have yet to ascertain whether the written terms of their plans and agreements providing for deferred compensation are in compliance with the requirements of §409A. A lengthy (396 pages to be exact) and complex set of 409A final regulations, issued in April 2007, will be enforced as of January 1, 2009.

##### **Q-2: Is there any possibility that the IRS will extend the December 31, 2008 compliance deadline?**

Not really. After granting several deadline extensions, there is no realistic prospect that the IRS will grant an additional one before year-end.

##### **Q-3: Can you remind us just what §409A is?**

Here is a synopsis of §409A:

§409A added to the IRC a set of specific restrictions on elections and distributions for compensation amounts deferred on or after January 1, 2005 in deferred compensation plans and arrangements. Deferred amounts earned and vested prior to January 1, 2005, together with any earnings thereon, are not subject to the requirements of §409A provided that they have not been

“materially modified” after October 2, 2004, i.e., the plan or arrangement involved has not enhanced an existing benefit or right or added a new benefit or right. ).

For a more extensive discussion of the legal aspects of §409A compliance and the consequences for failing to comply, please consult the FAQs that follow in the Appendix.

**Q-4: Are administrators of deferred compensation plans and arrangements holding deferred amounts that were earned and vested on or after January 1, 2005 expected to operate their plans and arrangements in compliance with §409A at this time?**

Yes. Since January 1, 2008, administrators should be operating their deferred compensation plans and arrangements in “good faith “compliance with §409A. See Appendix FAQ-1 for additional details.

**Q-5: What must a deferred compensation provider do to ensure timely compliance with §409A’s documentation requirements?**

The final regulations require the “material terms” of each deferred compensation plan and arrangement be in writing, describe who is covered, and specify the amount of compensation to be paid, the time of payment, and the form of payment.

**Q-6: Can you recommend steps that a deferred compensation plan sponsor should take now to comply with the documentation requirements of §409A?**

Yes, as follows:

1. Prepare an inventory of deferred compensation plans and agreements. (See the list of such documents provided in the Appendix FAQ-2). Determine whether any §409A exemptions are available.
2. Identify and list all provisions within each plan or agreement that must be changed to comply with §409A and its final regulations (for example, the addition of six-month delay provision for public companies, removal of haircut withdrawal provisions, disability and change-in-control definitional changes).

3. Confirm that each affected (non-exempt) plan or agreement includes all material terms required for compliance. Adopt all necessary amendments in accordance with applicable state corporate law and, when applicable, with federal securities reporting and disclosure requirements.

4. Prepare written explanations (such as a memorandum and/or PowerPoint slides) and schedule meetings with employees, directors, independent contractors, and other service providers to communicate these required changes to their plans and agreements.

5. Establish an internal administrative system to ensure compliance with reporting and withholding requirements; and 409A compliance with regard to future plans and agreements.

**Q-7: When should a service provider or service recipient retain experienced §409A legal counsel to assist?**

If you are a sponsor of, or a participant in, a plan, arrangement or agreement with provisions subject to §409A and have not yet had your documents reviewed and/or revised to comply with this section's statutory and regulatory requirements, you should contact legal counsel experienced with such matters immediately for guidance in timely complying with 409A requirements. If you are interested in retaining our legal services, we would be pleased to assist you. The firm's contact information is shown below.

**APPENDIX**

**FREQUENTLY ASKED QUESTIONS ABOUT §409A**

**FAQ-1: Is there any compliance relief for the period between 2005 to now?**

Yes, there is §409A Transitional Relief. Since 2005, deferred compensation plans subject to 409A's requirements that include amounts earned and vested on or after January 1, 2005 have been required to operate in "good faith" compliance with 409A. For the period after December 31, 2007 and before January 1, 2009, compliance with the final regulations (but not the proposed regulations) is deemed reasonable, good faith compliance with §409A. IRS Notice 2007-86 generally extends the compliance deadline for operating deferred compensation plans in accordance with the final regulations and for amending deferred compensation plans to December 31, 2008.

IRS Notice 2007-86 provides transitional relief that applies through the end of 2008. This guidance provides an employer with the opportunity to make some last minute adjustments, including principally as follows:

- A plan may provide for new payment elections on or before December 31, 2008, with respect to both the time and form of payment of deferred amounts, if such amounts were not otherwise payable within the same plan year. The election will not be treated as a change in time or form of payment or an acceleration of a payment, provided that the plan is so amended and elections are made on or before December 31, 2008.
- An election as to time or form of payment under a deferred compensation plan may continue to be linked to an election under a qualified retirement plan 403(b) annuities, section 457(b) plan or certain foreign broad-based plans through the end of 2008, provided payments under the nonqualified plan begin on or before December 31, 2008.
- Non-discounted stock options and stock appreciation rights may be substituted for discounted stock options and stock appreciation rights. The replacement stock option or stock appreciation rights will be treated for purposes of 409A as if granted on the grant date of the original stock option or stock appreciation right.

If you may have an interest in taking advantage of any of the foregoing transitional relief, you should be aware that additional technical requirements might be involved.

#### **FAQ-2: What plans and arrangements are subject to § 409A?**

For § 409A purposes, the term “nonqualified deferred compensation plan” is broadly construed to include almost any plan, arrangement or agreement that defers income taxation on compensation.

Below is a list of the types of plans and agreements typically subject to §409A’s requirements (notice the broad scope of this section’s coverage):

- Traditionally deferred compensation plans
- Employment offer letters
- Employment and consulting agreements (all, not just executive level)

- Reimbursement agreements
- Retention agreements
- Discounted stock options and discounted stock appreciation rights
- Phantom stock
- Restricted stock units
- Excess or supplemental benefit plans
- Annual and multi-year bonus plans
- Separation pay plans and agreements
- Salary continuation arrangements
- Director fee deferrals
- 457(f) plans
- Change in control agreements

Several categories are specifically excluded:

- Qualified retirement plans (including 403(b) annuities, SIMPLE plans, SEPs, governmental plans and eligible 457(b) plans).
- Certain welfare benefit plans and arrangements (plans providing vacation or sick leave, disability pay, pay for compensatory time, and death benefits; Archer Medical Savings Account, Health Savings Account, or other insured or self-insured health care reimbursement arrangements).
- Restricted stock, incentive stock options, grants under a qualified employee stock purchase plan, and nonqualified stock options with an exercise price no less than fair market value on the date of grant.
- Broad based foreign retirement plans.

**FAQ-3: What are there penalties for noncompliance with §409A's requirements?**

*Penalties for Plan Participants:* The penalties that are imposed upon a participant for the plan's noncompliance with 409A are severe:

- All deferred amounts will be immediately includible in the participant's current gross income if the compensation is no longer subject to a substantial risk of forfeiture and was not previously included in income.

- The participant will have to pay interest (for underpayment of taxes plus one percentage point) on all amounts that would have been included in income; and a 20 percent tax on amounts required to be included in income.

*Penalties for Providers:* A violation of §409A will also trigger reporting and withholding obligations upon employers and other service providers for deferred amounts includible in gross income.

#### **FAQ4: How do these deferral election requirements work?**

*Deferral Elections.* With few exceptions, 409A requires that the election to defer compensation be made by the participant prior to the beginning of the tax year in which services (relating to the deferred compensation) are rendered. This election must include the time and form of payment, if such terms are not already established by the plan's default provisions.

A service provider may make a subsequent election to change the time and/or form of payment under the following circumstances:

- The election will not take effect until at least 12 months after the date on which the election is made.
- The subsequent deferral must be made for a period of not less than five years from the date such compensation would otherwise have been paid (except for payments on account of death, disability, or an unforeseen emergency).
- Where payments are made under the plan at a specified time or pursuant to a fixed schedule, the election must be made at least 12 months before the payment is scheduled to be made (or before the first installment payment in a series of payments treated as a single payment).

#### *Deferral Examples:*

1. Suppose ABC Corporation sponsors a plan under which Employee A may elect to defer a percentage of his salary. To defer salary that is to be earned in calendar year 2009, Employee A must make a deferral election (including an election to defer as to the time and form of payment) no later than December 31, 2008. (Initial Deferral Election)

2. Employee A elects to be paid in a lump sum payment at the earlier of age 65 or separation from service. Since Employee A expects that he will work after he reaches age 65, and therefore wishes to defer payment to a later date, he makes a new deferral election by his 64<sup>th</sup> birthday, thereby entitling him to defer his lump sum payment to the earlier of age 70 or separation from service. Employee A may also elect to change the form of payment from a lump sum (if this option is available, of course) within this same time frame. (Note: multiple payment events are permitted under the rules). (Subsequent Deferral Election) & (Change in Time or Form of Payment)

3. Employee A participates in a deferred compensation plan that provides for a lump sum payment upon separation from service. He wishes to make the payment payable upon the later of separation from service or a predetermined age. He makes this election on or before the date 1 year before a separation from service, thereby entitling him to receive a lump sum payment upon the later of the date 5 years following a separation from service or at a specified age. (Subsequent Deferral Election)

*Performance-based Compensation.* A notable exception to the deferral rule described above involves performance-based compensation, i.e., compensation that is contingent upon the satisfaction of organizational or individual criteria, and the achievement of which must be substantially uncertain at the time the performance criteria are established. For performance-based compensation, a deferral election may be made as late as six months before the end of the performance period.

#### **FAQ-5: How do the distribution requirements work?**

Participants in a deferred compensation plan or arrangement are required to elect the time and method of distribution of their deferred amount when they make the deferral election, or they can rely upon the default distribution provisions in the plan or arrangement.

Distributions are limited to the following specific occasions:

- Death
- Disability
- Separation from Service (employment termination)
- Unforeseeable Emergency

- Change in Control
- A Specified Date or Pursuant to a Fixed Schedule

#### **FAQ-6: Are there any deferral exceptions to §409A?**

Yes. The most common are short-term deferrals, severance payments and reimbursements.

*Short Term Deferrals* §409A does not apply to short term deferrals, which are amounts actually or constructively received by the fifteenth day of the third month following the end of the taxable year in which the unconditional right to payment arises. This applicable 2-½ month period is measured by the period ending on the later of the fifteenth day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the fifteenth day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. This rule may apply separately to each payment in a series of payments made.

#### *Examples of Short Term Deferrals:*

1. Suppose that on November 1, 2008, ABC Corporation awards an unconditional bonus to Employee A. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee A on or before March 15, 2009.
2. Under the same set of facts above, except that ABC Corporation has a taxable year ending August 31: The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee A on or before November 15, 2009 (because the bonus is paid within 2 ½ month period following the service provider's first taxable year in which the payment is no longer subject to a substantial risk of forfeiture).
3. Under the first set of facts above, except that Employee A will forfeit the bonus if he does not continue to perform services through December 31, 2010: The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee A on or before March 15, 2011 (because the right to the payment is subject to a substantial risk of forfeiture through December 31, 2010).

4. Under the same set of facts above, except that Employee A will forfeit the bonus unless he continues performing services through December 31, 2010, and the bonus is scheduled to be paid as a lump sum payment on July 1, 2011: Here the bonus plan provides for a deferred payment. The bonus plan will not qualify as a short-term deferral regardless of whether the bonus is paid or made available on or before March 15, 2011 (because the bonus had specified a payment date after the applicable 2 ½ month period).

5. Under the same set of facts above, except that instead of the bonus being scheduled to be paid as a lump sum payment on July 1, 2011, the bonus provides that it will be paid upon Employee A's separation from service: Here the separation from service is an event that may occur after the applicable 2 ½ month period, and therefore the bonus plan will not qualify as a short-term deferral regardless of whether the employee separates from service and the bonus is paid or made available on or before March 15, 2009.

Separation Pay Plans. Severance paid upon involuntary separation (including a voluntary separation for "good reason") or pursuant to a window program are excepted from § 409A to the extent that it satisfies each of the following conditions:

- The separation pay (i.e., compensation payable only upon separation from service) does not exceed the lesser of (a) two times the service provider's annualized compensation or (b) two times the maximum amount a qualified plan could take into account under Code § 401(a)(17).
- The separation pay is paid no later than the last day of the second taxable year following the taxable year in which the separation from service occurs.

An amount that exceeds the separation pay limit above will be subject to § 409A only to the extent of the excess payment. Severance pay under foreign plans or collectively bargained plans is also exempt.

Reimbursements. Business related reimbursements are generally exempt from 409A if the expenses are incurred by the end of the second calendar year following the year in which separation from service occurs, and the

reimbursements are made by the end of the third calendar year following the year in which separation from service occurs.

### **FAQ 7: Are there special distribution requirements or prohibitions?**

Yes. If you are a public company or interested in accelerated payments, you should take note.

*Specified Employees.* Distributions to “specified employees” (generally, key employees) of a public company or its subsidiaries following a separation from service may not be made for at least six months following the date of separation, except when the separation is triggered by the employee’s death. This six-month delay rule must be stated in the plan or agreement.

*Acceleration of Payments.* An early withdrawal from the deferred compensation plan in exchange for a 10% reduction in the benefit (referred to as a “haircut” provision) is not permitted under 409A. In fact, payments generally cannot be accelerated except under limited conditions, such as:

- Entry of a domestic relations order
- Cash-out of a service provider’s entire interest under all similar deferred compensation arrangements if the amount is not greater than the annual 401(k) limit on pre-tax deferrals
- Complete termination and liquidation of all aggregated deferred compensation arrangements under specified limited circumstances
- Participant election changes to a qualified plan that is linked to amounts deferred under a nonqualified deferred compensation plan (unless otherwise permitted).

### **FAQ 8: What should be done if an operational error has already occurred?**

If you find that one or more operational errors may have already occurred, you should avail yourself of IRS Notice 2007-100. IRS Notice 2007-100 provides a procedure for correcting inadvertent operational errors that generally involve either: (1) deferred amounts that should have been paid (or should have been

paid sooner) in cash, or (2) cash payments of amounts that should have been deferred or should have remained deferred.

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