New Regs Require Action By Year-End on Deferred Compensation Plans

Insights
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On April 17, 2007, the Treasury Department released final regulations interpreting the nonqualified deferred compensation requirements of Section 409A of the Internal Revenue Code. Nonqualified deferred compensation that fails to satisfy the requirements of Section 409A is subject to punitive tax treatment and penalties.

The final regulations are effective on January 1, 2008. All deferred compensation plans and arrangements must comply in writing with the final regulations by December 31, 2007. Treasury Department officials have stated that this deadline will not be extended.

What Is Section 409A?
This new section of the Internal Revenue Code, added by the American Jobs Creation Act of 2004, created new comprehensive requirements for 'nonqualified deferred compensation plans.'

Section 409A was enacted to address some of the perceived executive compensation abuses that were discovered during many of the recent corporate scandals (i.e., Enron, WorldCom, etc.). The enactment also coincided with a recent Internal Revenue Service audit initiative focusing on executive compensation practices.

What Types Of Plans Are Affected?
These regulations affect any plan, program or arrangement that provides for the deferral of compensation from one tax year to another, other than 1) tax-qualified retirement plans, such as 401(k) plans, pension plans, etc., and 2) 'bona fide welfare benefit plans,' such as vacation leave, sick leave, disability leave, etc.

Typical examples include executive deferred compensation plans, which generally permit executives to voluntarily defer amounts of compensation that exceed the dollar amounts permitted under a 401(k) plan, and supplemental executive retirement plans (referred to as SERPs), which generally provide executives with certain defined retirement benefits beyond those that are available to most other employees. Both of these types of plans are typically referred to as ERISA 'top hat' plans, which must be unfunded and limited to a select group of management or highly compensated employees.

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Not-so-typical examples, which tend to be swept into the new broad definition of deferred compensation under Section 409A, are 1) 'phantom stock' or 'stock appreciation right' plans, 2) bonus plans (particularly long-term incentive plans) that pay out over multiple tax years, and 3) some types of severance arrangements that pay out over multiple tax years.

What New Requirements Are Created?
The new regulations impose significant restrictions on employee elections to change the timing or form of deferred compensation payments. They also limit permissible payment trigger events to termination of employment, disability, death, a previously specified point in time, or upon a 'change in control' of the employer. Each is specifically defined in Section 409A and the related Treasury Department guidance. Additionally, the regulations prohibit any discretionary acceleration of payments, except under certain very limited circumstances. While not necessarily unique to these type of plans, many of these new restrictions tend to have a significant impact on the operation of 'phantom stock' and 'stock appreciation right' plans.

Other Important Provisions
The penalty for violation is immediate taxation of all deferred amounts, plus interest and *an additional 20% penalty tax*. Generally, these requirements became effective on January 1, 2005, after which 'good faith compliance' was required, even if a plan was not yet amended to comply in writing. Now, all plans must be amended in writing by the end of this year. Of course, 'good faith compliance' is still currently required, regardless of the plan amendment deadline.

Action Plan
Employers should review all compensation plans, programs and arrangements to identify which ones provide for the deferral of compensation from one tax year to another. Keep in mind that bonus plans, severance plans and compensation arrangements outlined in employment agreements may be subject to the requirements of Section 409A, even though these types of arrangements were not previously considered 'deferred compensation' arrangements.

If you have questions, consult one of our Employee Benefits Practice Group attorneys at benefits@fisherphillips.com, or contact your regular FP lawyer for advice on what amendments, if any, you must make to your plans in order to bring them into compliance with the new comprehensive requirements of Section 409A.

This Legal Alert provides an overview of important aspects of this particular regulation. It is not intended to be, and should not be considered as, legal advice for any specific factual situation.

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