

Section 409A Compliance Deadline Fast Approaching

September 29, 2008

The December 31, 2008, deadline for compliance with Section 409A of the Internal Revenue Code ("Section 409A") is quickly approaching, and employers should thoroughly review all "nonqualified deferred compensation arrangements" (as broadly defined by the Internal Revenue Service) to ensure documentary compliance by year-end. In addition, any necessary amendments or restatements to such arrangements must be adopted no later than December 31, 2008.

Background

Amounts subject to Section 409A that are deferred under a nonqualified deferred compensation arrangement are subject to current income taxation unless the nonqualified arrangement complies in form and in operation with the election, distribution and acceleration requirements of Section 409A. Failure to comply with the Section 409A requirements at any time during a taxable year will cause all amounts deferred under the nonqualified arrangement for that year and all preceding taxable years to be included in the participant's gross income in the taxable year in which the failure occurred, to the extent such amounts are vested and were not previously included in income. Additionally, these amounts are subject to a 20% penalty tax plus interest at an enhanced rate on any resulting tax underpayments.

Notice 2007-86 (summarized in our October 24, 2007, Alert "[IRS Extends Section 409A Transition Relief to December 31, 2008](#)") provided that documentary compliance with the provisions of the final regulations under Section 409A is required on January 1, 2009. Therefore, nonqualified deferred compensation arrangements must be amended to conform to the provisions of Section 409A and its regulations by December 31, 2008.

Year-End Action Items

The following are steps that employers should take prior to year-end in order to avoid the harsh consequences of a Section 409A violation.

1. Identify and review all compensation arrangements for Section 409A compliance. Arrangements that may be subject to Section 409A include:

- Traditional SERPs and other deferred compensation plans;
- Employment, change in control and severance agreements;
- Severance plans;
- Stock options, stock appreciation rights, restrict stock units and other equity awards;
- Post-retirement reimbursement and in-kind benefit arrangements;
- Annual bonus and long-term incentive plans;
- Non-U.S. benefit plans that cover U.S. employees;
- Employee stock purchase plans not covered by Section 423 of the Internal Revenue Code; and
- "Earn-outs" and other arrangements entered into in connection with corporate transactions.

2. Amend compensation arrangements as necessary for Section 409A compliance. Typically, such compensation arrangements are amended to either satisfy the requirements of Section 409A or fall outside the coverage of Section 409A altogether through an exception such as the short-term deferral exception.
3. Review equity grants for Section 409A compliance and take any necessary corrective actions, particularly with regards to options granted with an exercise price below fair market value on the grant date.
4. Take advantage of the last chance for maximum payment flexibility. Through December 31, 2008, employers and employees may continue to change the payment and/or form for Section 409A amounts without regard to the general "no acceleration" and "12-month/5-year" rules that will apply after 2008. The main restriction on this payment flexibility is that distributions may not be moved into or out of 2008. Employers and employees are encouraged to use this payment flexibility before year-end.
5. In addition to the necessary amendments to plans, employers should confirm their operational compliance with Section 409A. Operational compliance with Section 409A has been required since the adoption of Section 409A.

Conclusion

While various commentators have requested for the Internal Revenue Service to extend the Section 409A compliance deadline further, at the time of publication, there has been no indication that such requests would be granted. Therefore, employers should review all possible Section 409A arrangements for compliance and take any necessary corrective action prior to the December 31, 2008, deadline. With this deadline approximately three months away, employers that have not begun the Section 409A compliance process already should act immediately.

For Further Information

If you have a question about this Alert or would like more information, please contact group chair [W. Michael Gradisek](#), [John A. Reade, Jr.](#), [Lawrence I. Davidson](#), any of the other [attorneys](#) in the [Employee Benefits and Executive Compensation Practice Group](#) or the attorney in the firm with whom you are regularly in contact.

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