

**Immediate Action Required for
Section 409A Compliance**

All “nonqualified deferred compensation plans” subject to Section 409A of the Internal Revenue Code must comply with new rules by December 31, 2008. Any failure to do so will expose executives, employees and others (including directors and other independent contractors) who are the intended beneficiaries of these arrangements to accelerated income tax, interest charges and a 20 percent excise tax.

The first step is the identification of subject “plans,” which is defined to include contracts with individual “service providers” (that is, employees and certain independent contractors). Any existing employment agreement or consulting agreement, bonus arrangement or policy, equity incentive plan, excess benefit or supplemental retirement plan (SERP), employment termination arrangement, and severance plan as well as any conventional deferred compensation plan or agreement should be reviewed to determine whether it is subject to Section 409A. If any such arrangement grants a service provider a legally binding right to compensation that is not currently received but is payable in a later taxable year, the arrangement will have to comply with Section 409A or establish an exception to Section 409A compliance. Exceptions from Section 409A compliance cover:

- qualified retirement plans,
- Section 403(b) tax-deferred annuities,
- Section 457(b) eligible deferred compensation plans,
- SEPs and SIMPLE individual retirement accounts,
- tax-exempt welfare benefits such as group medical plans,
- stock options that have an exercise price that is not less than fair market value on the date of grant,
- severance pay provided in the event of an involuntary separation from service under a collective bargaining agreement,
- severance benefits payable only on an involuntary separation from service that meet the “separation pay” exemption (benefits limited to twice the employee’s annual rate of pay or twice the annual compensation limit for qualified retirement plans, currently \$230,000, whichever is less) or the short-term deferral exemption

(benefits expressly required to be paid within two and one-half months of the close of the year in which the benefits vest).

Even if an exception to Section 409A is available, language changes may be appropriate to reflect specific Section 409A terminology. For example, the Section 409A regulations provide very specific definitions for terms such as “involuntary separation from service,” “separation from service,” “termination of employment,” termination for “good reason,” “change in control,” and “disability.” These terms are important for Section 409A compliance, which permits the payment of benefits under subject arrangements *only* upon death, disability, separation from service, change in control, unforeseeable emergency or a payment date or schedule of payments that is fixed in advance. Also note that Section 409A definitions will apply to establish the availability of certain Section 409A exemptions, such as the separation pay and short-term deferral exemptions referred to above.

Section 409A also imposes restrictions on plans which allow participants to make elections to defer a portion of their compensation, a six-month delay on payment of benefits to specified employees of public companies, and limits on the acceleration and postponement of the payment of benefits (see “New Deferred Compensation Rules” at www.benefitslawgroupofchicago.com/HTML/new-deferred-compensation-rules-2005.htm for details.

Remember, document compliance is required under Section 409A (including any subject arrangements that have not yet been reduced to writing, such as informal severance pay policies) by December 31, 2008. General amendments that simply recite that the subject arrangement is to be interpreted in accordance with Section 409A will *not* be recognized by the IRS as a valid approach for document compliance. Also bear in mind that retroactive amendments are not permitted. The December 31, 2008 deadline will apply with only limited exceptions available under an Internal Revenue Service correction procedure that has not yet been fleshed out with definitive regulations.

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