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DEFERRED COMPENSATION ACTION ALERT

November, 2007

Executives and Others Face Tough Tax Liability Unless Deferred Compensation Deals Timely Updated For New Code Section 409A Compliance

American businesses and their employees and other service providers frequently participate in employment or settlement agreements, incentive compensation, deferred compensation plans or other deferred compensation arrangements that defer payment of compensation for services performed in one taxable year until a later year. Parties sponsoring or entitled to receive compensation under these deferred compensation plan need to act promptly to evaluate the implications of new Internal Revenue Code ("Code") § 409A upon such arrangements to avoid unintentionally triggering harsh tax consequences for employee or service provider entitled to receive the compensation.

On October 22, 2007, the Internal Revenue Service ("IRS") granted employers additional time to finishing updating "deferred compensation plans" covered by Code § 409A to comply with the broad reaching provisions of § 409A. While providing welcome breathing room, most businesses and employees involved in deferred compensation arrangements covered by Code § 409A still will need to act expeditiously to ensure that necessary arrangements to update their particular deferred compensation arrangements are timely completed.

Enacted to curb perceived abuses related deferred pay and other compensation arrangements for high-ranking executives, Section 409A essentially regulates any arrangement that defers compensation other than those specifically exempt from its provisions. Code § 409A defines "deferred compensation plan" broadly to reach to a wide range of practices and arrangements. Because of the broad definition of "deferred compensation plan" employed by Code 409A, it impacts virtually all types of pay and compensation practices that operate to defer the payment of compensation beyond the tax year of the taxable year of the performance of services giving raise to the compensation right. As defined by Code § 409A an arrangement generally provides for the deferral of compensation if, under the terms of the plan or other arrangement and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. Accordingly, Section 409A impacts deferred compensation and pay arrangements established pursuant to formal deferred compensation plans, as well as those created by employment agreements, severance agreements, settlement agreements, certain bonus agreements, change of control and other corporate transactions, and a host of other contexts.

Until October 22, 2007, businesses and employees faced a December 31, 2007 deadline to update deferred compensation plans to comply with Code § 409A. In Notice 2007-86, however, the IRS granted additional time for employers to finish updating deferred compensation plans subject to Code § 409A to comply with from December 31, 2007 to December 31, 2008, provided that the arrangements are operated in good faith operational compliance with final regulations published earlier this year for the period from January 1 to December 31, 2008.

Added to the Code by Section 885 of the American Jobs Creation Act of 2004 (the "Act") and applicable to virtually all nonqualified deferred compensation practices, plans and arrangements, Code § 409A will impose punitive tax consequences upon employees and other service providers entitled to receive deferred compensation under a deferred compensation plan or other covered deferral arrangement unless the arrangement either meets the requirements of § 409A or otherwise qualifies as exempt from its provisions. If a deferred compensation arrangement does not comply with Code § 409A or otherwise qualify as exempt from its provisions, the employee or other service provider earning the compensation immediately incur the following liability to the IRS:

- Income tax on all amounts deferred under the arrangements regardless of whether the taxpayer is entitled to payment of that compensation at that time;

- A 20% penalty tax; and
- Interest is assessed at a "nonpayer rate" (which is higher than that imposed for other violations) plus 1% from the date or dates of deferral.

This liability will arise in the year that the employee obtains a right to receive the compensation that is not subject to a substantial risk of forfeiture regardless of whether the employee in fact then has a right to receive the compensation or whether the arrangement otherwise meets applicable requirements to qualify for deferred taxation under other relevant provisions of the Code.

Furthermore, if the employer seeks to protect an affected employee from the taxes and penalty by making tax protection payments to cover the tax liability triggered by Code § 409A, Code § 409A will bar the employer from deducting the tax protection payments and impose additional excise tax liability equal to 20% of the amount of any such tax-protection payment on the recipient employee or other service provider.

Final regulations construing Code § 409A exempt various compensation arrangements from its provisions. Employers planning to treat one or more compensation arrangements as exempt from the Section 409A mandates beware, however. While the IRS granted additional time for employers to bring covered deferred compensation arrangements into compliance with § 409A, the guidance does not grant additional time to redesign existing programs to qualify as exempt from § 409A. Therefore, employers desiring to treat any deferred compensation arrangements as exempt from Section 409A should act quickly to ensure that that those compensation arrangements intended to qualify as exempt meet all of the conditions for exemption by December 31, 2007.

Some of the more notable highlights of Notice 2007-86 include the following:

- Employers have until December 31, 2008 to amend plans and arrangements to comply with § 409A and the final regulations, including the specification of the time and form of payment;
- Nonqualified deferred compensation arrangements subject to § 409A must operationally comply with § 409A on a reasonable, good faith basis based on the statute and any generally applicable guidance issued through December 31, 2008;
- Until January 1, 2008, the IRS will not require compliance with either the QACA Rule issued in October 2005 or the final regulations but will treat compliance with either guidance as reasonable, good faith compliance; After January 1, 2008, however, reliance on the QACA Rule will no longer be permitted;
- The reasonable, good faith standard will be treated as violated if the employer exercises discretion under a plan in a manner that causes the plan to fail to meet the requirements of § 409A;
- Plans may permit changes to existing elections as to the form and time of payments through December 31, 2008 provided that such changes made in 2008 can't apply to amounts that would otherwise be payable in 2008 or cause an amount to be paid in 2008 that would otherwise not be payable in 2008;
- Payment elections under a nonqualified deferred compensation plan may still be linked to elections under a qualified retirement plans, a § 403(b) annuities, § 457(b) eligible plans or certain foreign broad-based retirement plans through December 31, 2008;
- The Notice extends the relief set forth in Notice 2005-1 and the preamble of the QACA Rule that permitted the substitution of nondiscounted stock options or SARs for discounted stock options or SARs to allow before December 31, 2008 the replacement of a stock option or SAR that otherwise provides for a deferral of compensation under § 409A with a stock option or SAR that satisfies the criteria for exemption from the application of § 409A subject to fulfillment of certain specific conditions; and
- The Notice affirms the IRS plans to establish a program for correcting certain § 409A errors in the near future.

Accordingly, to avoid triggering unintentionally the punitive tax penalties of § 409A, employers should continue to move expeditiously to identify all arrangements potentially impacted by Code § 409A and to act to redesign and redeploy those arrangements either to comply with Code § 409A, to qualify for exemption from its provision, or to otherwise to assess and report tax as required to comply with Code § 409A. To this end, employers and employees or other service providers involved in these arrangements that have not already done so should take prompt action to:

- Inventory all compensation and pay arrangements to identify those that may provide "deferred compensation;"
- Identify those arrangement subject to the Section 409A rules and those that may qualify as exempt under the final regulations;

- Assess the extent to which each applicable deferred compensation arrangement in form and operation complies with the requirements of § 409 or, where applicable, the conditions for exemption;
- Act promptly to implement any corrections necessary to preserve any desired ability to treat a deferred compensation arrangement as exempt from Code § 409A before December 31, 2007, pending further guidance;
- Administer all covered deferred compensation arrangements to comply with Code § 409A after December 31, 2007;
- Timely amend all covered deferred compensation arrangements to comply with Code § 409A by December 31, 2008; and
- Operate all programs potentially covered by Code § 409A in operational compliance with the final regulations published earlier this year.

If you have questions about or need assistance to respond to Code § 409A or other matters relating to the design or administration of your employee benefit plans or human resources practices, contact Cynthia Stamer at 972.419.7188 or cstamer@gpm-law.com.

The U.S. Department of Labor Employee Benefits Security Administration ("EBSA"), the Internal Revenue Service ("IRS") and the Pension Benefit Guaranty Corporation ("PBGC") recently released advance informational copies of the 2007 Form 5500 Annual Return/Report of Employee Benefit Plan and related instructions ("Form 5500").

The Form 5500 package released October 10, 2007 includes several changes compared to the 2006 Form 5500 Forms. Significant changes to the 2007 Form 5500 package include:

- A new simplified reporting option for eligible plans with fewer than 25 participants required by the Pension Protection Act ("PPA"); and
- Revised Schedule B instructions to reflect the updated mortality tables and the list of codes used for valuation purposes, as well as for calculating current liability for plan years beginning on or after January 1, 2007.

Instructions included in the package also caution 2008 Form 5500 filers to expect additional changes to the 2008 Form 5500 package in response to changes required to comply with the PPA. Given these expected changes, the EBSA is warning plan administrators expecting to file 2008 short plan year Form 5500s to anticipate that it may be necessary for them to delay preparation of the 2008 short plan year return until the 2008 forms become available for use.

Subject to limited exceptions, all ERISA plan administrators generally are required by ERISA to file an annual Form 5500 for their employee benefit plans. Separate Form 5500 filing obligations also may apply under the Internal Revenue Code (the "Code").

All plan administrators and plan sponsors need to keep in mind that timely filing of Form 5500 is important. Plan administrators caught by the EBSA failing to file required Form 5500s can face stiff penalties. For instance, under existing EBSA enforcement policy, plan administrators filing annual reports after the date the report was required to be filed (a "late report") may be assessed $50 per day, with no limit, for the period they failed to file, determined without regard to any extensions for filing. Plan administrators caught by the EBSA failing to file an annual report may be assessed a penalty of $300 per day, up to $30,000 per year, until a complete annual report is filed. Plan administrators who presently are exposed to these penalties due to an unresolved failure or untimely filing required by ERISA can qualify for reduced penalties by filing these forms in accordance with the EBSA's existing Delinquent Filer Voluntary Compliance Program ("DFVC Program"). The EBSA recently has released a tool to help plan administrators calculate their penalties under the DFVC Program.

For plans subject to Form 5500 filing obligations under the Code, the Code imposes separate penalties, which are administered and assessed by the IRS. Accordingly, the DFVC program does not resolve any penalties assessable under the Code. Rather, tax penalties for non-filing or late filing in violation of the Code must be resolved separately with the IRS.

If you have questions about the Form 5500 or other ERISA matters relating to the design or administration of your employee benefit plans or human resources practices, contact Cynthia Stamer at 972.419.7188 or cstamer@gpm-law.com.

Other Information & Resources

If you have questions or concerns about the matters discussed in this publication or other employee benefit, compensation or human resources matters, wish to obtain information about arranging for training or presentations by Ms. Stamer, wish to suggest a topic for a future program or publication, or wish to request other information or materials, please contact: Cynthia Marcotte Stamer, P.C., Member, Glast, Phillips & Murray, P.C., 2200 One Galleria Tower, 13355 Noel Road, LB 48, Dallas, Texas 75240. Telephone (972) 419-7188. E-mail cstamer@gpm-law.com. You also can register to receive future updates and information about upcoming programs, access other publications by Ms. Stamer and other helpful resources or additional information about Ms. Stamer and/or Glast, Phillips & Murray, P.C., at CynthiaStamer.com or by contacting Ms. Stamer directors. We hope that this information is useful to you. If you or someone else you know would like to receive future Alerts or other information about developments, publications or programs, please be sure that we have your current contact information – including your preferred e-mail. Interested persons can register or update their contact information by providing that information to us through registration on our website at www.cynthiastamer.com or via telephone, fax or e-mail.

About Cynthia Marcotte Stamer

Board Certified In Labor and Employment Law by the Texas Board of Legal Specialization, attorney Cynthia Marcotte Stamer has more than 20 years experience helping employers and business leaders, health plan fiduciaries and administrators, insurers and others design, implement, administer and defend health and other employee benefit and compensation, insurance and other human resources practices, policies and strategies. Ms. Stamer is recognized for her work helping clients design and administer legally compliant employee benefit and human resources programs, practices and products for employer, employee benefit, and insurance and financial services industry clients.

Recognized in the International Who's Who of Professionals and bearing the Martindale Hubble AV-Rating, Ms. Stamer is a highly regarded legal advisor and consultant, author and speaker, who regularly conducts management and other training on a wide range of employee benefit, human resources and internal controls, and other related risk management matters. Ms Stamer is the author of 100s of publications on a host of human resources and related issues. Her writings have appeared in a variety of other publications, including works published by the American Bar Association, Aspen Publishers, BNA, the American Health Lawyers Association, and Government Institutes, Inc. and others. For a listing of some of these publications, see cynthiastamer.com. Her insights on human resources risk management matters also have been quoted in The Wall Street Journal, various publications of The Bureau of National Affairs and Aspen Publishing, the Dallas Morning News, Spencer Publications, Health Leaders, Business Insurance, the Dallas and Houston Business Journals and a host of other publications. She also serves in leadership positions in numerous human resources, corporate compliance, and other professional and civic organizations including Chair of the American Bar Association (ABA) Health Law Section Managed Care & Insurance Interest Group, and Vice Chair of both the ABA Real Property, Probate & Trust Section Employee Benefits & Compensation Group and the ABA TIPS Worker's Compensation Committee, and a Continuing Education Liaison for the ABA Joint Committee on Employee Benefits and as a member of the IRS TEGE Council. For more details about Ms. Stamer's experience and other credentials, contact Ms. Stamer or see www.CynthiaStamer.com.

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