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November 2008

With year-end approaching, employers should make certain they have taken all steps necessary to comply with rules governing deferred pay arrangements.

## **A Section 409A Year-End Reminder: Action May Be Required Now**

By Steven J. Friedman

As the end of 2008 quickly approaches, employers should review whether they have taken sufficient steps to become compliant with the provisions of Section 409A of the Internal Revenue Code ("Section 409A"), which governs deferred compensation arrangements. The purpose of this newsletter is to discuss certain items that employers must focus on by year-end 2008 to ensure compliance with Section 409A. For a more detailed description of Section 409A, please see Littler Insight, *Section 409A Broadly Impacts Employment Agreements, Severance Arrangements and Settlement Agreements*; Littler's Benefits ASAP, *Final Section 409A Regulations Affect a Wide Range of Compensation Devices and Require Employer Action by Year-End*; and Littler's Benefit ASAP, *IRS Extends 409A Compliance Deadline and Provides Guidance on 409A Reporting*.

Section 409A provides rules that dictate when deferred pay can be distributed to employees, the permissible forms of payout and how elections to defer pay need to be structured. Deferred pay arrangements that are subject to Section 409A include an extremely broad range of compensation devices. These include termination payments under employment agreements, severance pay, short and long-term bonuses, long-term incentive plan (LTIP) payments, stay bonuses, signing incentives and change in control agreements, as well as equity based compensation, non-qualified plans and traditional deferred pay plans. Broadly, these rules govern pay that is earned in one year and paid in a later year.

If the provisions of Section 409A are not followed, income taxes will be accelerated to the time of the violation, and a 20% additional tax, plus an interest penalty, will be assessed on the employee who has earned the deferred compensation. In California, an additional 20% penalty and interest penalty will apply.

### **Good Faith Compliance Period Ending**

From the time Section 409A became law in 2005 until now, the IRS has provided that compliance could be in the nature of "good faith compliance." However, the good faith

compliance period ends December 31, 2008 and, after this date, deferred compensation arrangements must be in strict compliance with 409A's rules.

## Plan Documentation Must Be in Place

Section 409A provides that prior to January 1, 2009, deferred pay arrangements must be in operational compliance with the rules. However, appropriate plan documentation need not be in place prior to this date. On January 1, 2009, written documentation must contain all operative terms of the deferred pay arrangement. These include the manner in which pay is deferred, the time and form of payout for such compensation, the identity of the individuals who participate in the Plan, the manner in which the designated form and time of payout could be changed, whether a series of payments will be viewed as a single payment or separate payments, and the manner in which a six-month hold on payouts to "specified employees" will be implemented.

After 2008, if arrangements subject to 409A have not been properly documented, a Section 409A violation will occur, even if the operative statutory and regulatory rules are otherwise followed.

Employers may not realize the many types of pay deferrals that are required to be reduced to writing. One area of concern is annual nondiscretionary bonuses where employees are paid out in the year following the year they earn the bonus payment. Another area involves separation pay that extends beyond the current taxable year. Depending upon the facts and circumstances of the pay arrangement, Section 409A may be triggered.

Special care should also be taken to assure that the distribution of nonqualified deferred compensation is limited to permissible "distribution events." For example, "separation from service" is a permitted distribution event, however, there may not be a separation from service if a former employee continues to work in a similar capacity as an independent contractor. Depending upon the provisions in a document, this term may need to be differentiated from a "termination of employment" (which may or may not be a separation from service). Section 409A provides for only five permissible distribution events: (1) separation from service; (2) disability; (3) change in control; (4) specified date or fixed payment date; and (5) death. If separation from service, disability or change of control is used as a permissible distribution event, then those events must comply with the Section 409A definitions.

Also, although employers may be cognizant of the rules that require a six-month hold on payouts to certain "specified employees," care should be taken that the methodology contained in Section 409A is followed in identifying specified employees.

## New Elections Relating to Time and Form of Payout May Be Adopted This Year

On or before December 31, 2008, deferred pay arrangements may be revised to provide new forms of payout (i.e., lump sum or installments) and new dates for payments to be made. If an existing payout structure does not comply with the rules set forth in Section 409A, it must be changed. Although the new payout structure can be very different from an existing structure, it can neither accelerate a payment into 2008 that would otherwise be paid in a later year, nor delay into a later year a payment that otherwise would be paid in 2008. When 2008 ends, employers will no longer have the opportunity to change the time and form of a payout that has been previously deferred without complying with 409A's subsequent deferral rules. These rules require that a change election be made and irrevocable at least one year prior to the time that payment is scheduled to be made and that there be an extension of the payout time to at least five years after the original date of payment.

## Immediate Action Required

Employers that have not already done so should identify all deferred pay arrangements that they maintain and determine which arrangements are subject to Section 409A. Once identified, arrangements that are determined to be subject to Section 409A must be brought into Section 409A compliance by December 31, 2008.

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