

Deferred Compensation - 409A Compliance Deadline Looms

A vertical graphic on the left side of the page. It features a metal IV stand with a white plastic drip chamber hanging from it. The words 'CLIENT ADVISORY' are printed vertically in large, black, sans-serif capital letters on the white chamber. Below the chamber, a clear plastic drip chamber and a tube are visible.

CLIENT ADVISORY

HANCOCK, DANIEL, JOHNSON & NAGLE, P.C.

Background

IRS regulations regarding Section 409A of the Internal Revenue Code will become effective on January 1, 2009. Section 409A was enacted in 2004 to limit favorable income tax treatment of nonqualified deferred compensation to arrangements that meet specified design and operational requirements. The rules include: restrictions on deferral elections and changes to elections, limitations on the time and form of payments (only six permissible payment events), a prohibition on accelerated payments, restrictions on funding, and requirements for tax reporting and withholding. Since 2004, the Internal Revenue Service has issued regulations, several notices, and other guidance providing transition relief to assist companies in bringing compensation arrangements into compliance with Section 409A. The transition relief period ends on December 31, 2008.

Failure to Comply

If an arrangement subject to Section 409A fails to comply with requirements, the employee or other service provider (e.g., director, independent contractor, or consultant) will be subject to:

- accelerated taxation of the noncompliant compensation and all

of the same type of compensation (even if no payments are received);

- an additional 20% federal income tax on the compensation amount; plus
- interest at the underpayment rate plus 1%.

Broad Reach of Statute

Many employers are surprised to learn how broad the definition of a nonqualified deferred compensation plan ("NQDC") is for purposes of Section 409A. Section 409A governs most nonqualified deferred compensation provided by employers to their employees and independent contractors (e.g., consultants and non-employee directors), including traditional deferred compensation plans, excess benefit plans, and SERPs (supplemental executive retirement plans). But 409A also governs many other payments of compensation that are not normally thought of as providing "deferred" compensation, including payments made upon severance from employment (either through severance pay plans, or pursuant to the terms of employment agreements), expense reimbursements, bonus awards and payments upon death or disability. Section 409A also imposes strict rules with respect to certain arrangements providing for stock or other equity compensation.



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Employer Action Required By Year-End

During 2008, special transition rules apply under Section 409A, so that plans and arrangements can be revised in order to come into compliance with the 409A rules. Effective January 1, 2009, the new rules will be fully in effect, and the ability to change the form or timing of payments of deferred compensation and remain in compliance with 409A (and thereby avoid the onerous tax results that come from noncompliance) will be severely limited. Accordingly, **immediate attention is required** by all employers that maintain arrangements that may be subject to the rules under 409A (referred to here as non-qualified deferred compensation plans, or NQDCPs), as the deadline for compliance with Section 409A is fast approaching, and the consequences of a failure to comply can be significant.

Actions to Take Now

We recommend that plan sponsors take (or, if already started, complete) the following steps:

- Identify All Impacted Arrangements. Identify and review all plans, agreements and arrangements (other than tax qualified plans) that may provide deferred

compensation to their employees or independent contractors (e.g., consultants).

- Determine Availability of Exemptions. Determine if the identified NQDCPs provide compensation that is (or can be structured to be) exempt from Section 409A.
- Check Time and Form of Payment Elections. For NQDCPs that are subject to Section 409A, determine whether the elections to defer compensation and the provisions governing the time and form of payment meet the requirements of 409A. In doing so, remember that the special transition period opportunity to modify the time and form of payment ends on December 31, 2008.
- Review Procedures. Review operational and administrative procedures supporting the NQDCPs to determine if 409A compliance will require any changes to such procedures.

For more information about the 409A Compliance Deadline please contact either Kimberly W. Daniel at (804) 967-9604, or Ryan P. Waid, at (866) 967-9604 or by email (kdaniel@hdjn.com or rwaid@hdjn.com).

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