

## Treasury and IRS Release Long-Awaited Final Regulations on Deferred Compensation Under Code Section 409A

April 13, 2007

On April 10, 2007, the Treasury Department and the IRS issued final regulations relating to nonqualified deferred compensation plans under section 409A of the Internal Revenue Code. Section 409A imposes restrictions on deferral elections, distribution elections, distribution events, and acceleration of payments. Failure to comply with section 409A will result in immediate taxation of the deferred amounts, an additional penalty of 20%, and the assessment of additional interest.

The newly released final regulations incorporate and expand upon the guidance provided under proposed regulations issued in September 2005. The deadline for plan sponsors to amend plan documents to conform to the section 409A requirements and for employees to amend their payment elections (for payments not otherwise payable in 2007) remains December 31, 2007.

Plan sponsors need to review immediately all deferred compensation plans and arrangements, including employment agreements and severance pay arrangements. Plan sponsors will have to amend their plans and agreements to comply with section 409A on or before December 31, 2007. IRS guidance permits a broad variety of remedial actions to bring nonconforming arrangements into compliance with section 409A, but such actions must be taken by December 31, 2007.

### Highlights of the Final Regulations

- *Equity Compensation*: The final regulations significantly expand the circumstances under which the exercise period of an option can be extended without violating section 409A. The final regulations also expand the definition of “service recipient stock” that may be subject to stock options and stock appreciation rights, and they include requirements for determining the fair market value of stock of privately held entities. We will distribute a separate LawFlash further detailing the guidance contained in the final regulations on equity compensation.
- *Severance*: The final regulations exempt certain severance plans that provide for payment in the event of involuntary termination from the ambit of section 409A. The regulations also allow employment agreements to contain certain “good reason” provisions without adversely affecting the ability to use the “severance plan” exception or the “short-term deferral” exception to section 409A. While the six-month postponement period for distributions to key employees continues to apply, under the final regulations, a properly designed employment agreement or separation agreement can be structured to minimize the effect of the six-month postponement

period for key employees. We will distribute a separate LawFlash further detailing the guidance contained in the final regulations regarding severance pay.

- *Short-Term Deferrals*: As under the proposed regulations, the final regulations generally exclude from section 409A payments made within 2½ months of the close of the year in which they vest. The terms of the plan must provide for payment within the short-term deferral period.
- *Deferral Elections and Distribution Requirements*: The final regulations address many of the issues raised by the proposed regulations, including clarification of the rules relating to reimbursements and tax gross-ups. The regulations clarify the circumstances under which the timing of distributions can be based on an objective formula, such as profits. The regulations also provide guidance and some flexibility for determining when an employee has separated from service. We will distribute a separate LawFlash further detailing the guidance contained in the final regulations on deferral elections and distribution requirements.
- *Foreign Arrangements*: The final regulations provide additional guidance relating to the application of section 409A to nonresident aliens and foreign deferred compensation plans.
- *Plan Terms*: All plans and arrangements providing deferred compensation must be amended to comply with section 409A by December 31, 2007. The final regulations do not allow plan sponsors to rely on general “savings clauses” in documents; instead, the plan documents must include the appropriate 409A terms.
- *Split-Dollar Arrangements*: IRS Notice 2007-34 provides guidance regarding the application of section 409A to split-dollar arrangements. We will distribute a separate LawFlash further detailing the guidance contained in the final regulations with respect to split-dollar arrangements.

While we expect the IRS to issue additional guidance regarding section 409A, the final regulations will form the basis for all action that needs to be taken in 2007.

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