As appeared on Law.com, June 28, 2007

Final 409A Regulations: What You Need to Know and Do by Year End

June 28, 2007

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Corporate human resources and legal departments have been busy these past few years implementing procedures to comply with strict new laws governing executive compensation, including, notably, the Sarbanes-Oxley Act of 2002 and the new SEC executive compensation disclosure rules. And 2007 is proving to be no exception.

What You Need To Know About 409A

In April, the Treasury Department and the Internal Revenue Service issued final regulations on a relatively new deferred compensation law known as "409A." Companies have until the end of 2007 to amend their plans to be exempt from or comply with this new relatively new law.

Section 409A of the Internal Revenue Code was enacted as part of the American Jobs Creation Act of 2004 to curb abuses in executive compensation made famous by the collapse of Enron Corp. Section 409A imposes strict new rules on deferred compensation elections, payments and funding and imposes severe tax consequences on plan participants if the new rules are not followed. These severe tax consequences include a 20 percent penalty tax, immediate taxation on vesting and interest at the federal underpayment rate plus one percent. Section 409A also imposes reporting and disclosure obligations on companies.

Section 409A is extremely broad in scope. It affects not only traditional deferred compensation plans but also many other arrangements that are not thought of as deferred compensation, including, for example, equity arrangements, employment agreements, severance plans, bonus plans, foreign plans and private equity deferral arrangements.

Deferred compensation that is earned and vested before 2005 is generally exempt from 409A, as long as the arrangement providing for the deferred compensation is not "materially modified" after Oct. 3, 2004. Companies should be extremely careful when considering amendments to any arrangement that may be grandfathered under 409A.

Since 409A was enacted, the Treasury Department and the IRS have struggled to provide meaningful guidance that balances the intent of Congress with the practicalities of corporate America. In late 2004 and the fall of 2005, interim guidance was issued that contained a number of welcomed exemptions, including exemptions for short-term deferrals, equity compensation and separation arrangements, and that provided helpful transitional relief. The final 409A regulations, which together with the preamble are almost 400 pages in length, clarify and expand many of these exemptions and provide guidance on how to amend plans to comply with 409A.

What You Need To Do Before Year End

Given that there are only six months left until year end, companies must act quickly to ensure each arrangement that may be subject to 409A will be amended to either be exempt from 409A or comply with 409A.

This will require companies to review each of their deferred compensation arrangements and take necessary corporate action to adopt formal plan amendments before year end.

409A Year-End Action Plan

Establish a 409A team, including key people from HR, benefits and compensation, finance, legal, tax, payroll, IT and outside consultants including actuaries, third-party administrators and legal advisers.

Establish a time frame for identifying and amending plans and implementing changes to payroll and IT. In establishing the deadline for plan amendments, consider working backwards from the late summer or early fall (or second to the last) board meeting for 2007 to ensure that there is time to adopt any clarifying amendments by year end.

Identify all plans, programs and arrangements that may be subject to 409A. (See sample checklist below.)

Identify issues and make decisions related to plan amendments, including, for example, whether to create separate plans for grandfathered amounts and amounts subject to 409A and whether to make a plan exempt from or compliant with 409A.

Draft plan amendments, circulate plan amendments to the 409A team and prepare final amendments for compensation committee and board approval where necessary.

Obtain necessary committee and board approvals.

File any SEC-related documents required for changes to equity based plans.

Communicate affect of plan amendments to plan participants.

Obtain consent of plan participants were required.

Implement procedures to ensure that all deferred compensation arrangements remain grandfathered, exempt from or compliant with 409A.

Implement internal and external payroll and IT procedures to comply with 409A reporting and disclosure requirements where necessary

Checklist of Arrangements

The following should be reviewed for 409A issues.

Traditional deferred compensation arrangements:

a. Elective deferral arrangements;
b. Excess 401(k)/spillover plans;
c. Excess defined benefit plans; and
d. Rabbi trusts and other financing
e. arrangements.

Bonus and incentive compensation arrangements:

a. Short-term incentive plans;
b. Long-term incentive plans; and
c. Performance plans.

Equity plans and awards and equity-based plans and awards:

a. Stock options (nondiscount stock options are generally exempt from 409A);
b. Stock appreciation rights (nondiscount stock appreciation rights are generally exempt from 409);
c. Restricted stock (generally, exempt from 409A);
d. Restricted stock units;
e. Phantom stock; and
f. Employee stock purchase plans (generally, exempt from 409A.

Director compensation arrangements:

a. Compensation agreements;
b. Equity awards; and
c. Deferral arrangements.

Employment agreements:

a. Formal employment agreements;
b. Letter agreements/offer letters;
c. Expatriate agreements; and
d. Retention agreements.

Severance arrangements:

a. Severance plans;
b. Severance/separation agreements; and
c. RIF letter agreements.

Change of control agreements.

Independent contractor agreements.

Fringe benefit/perquisite arrangements.

Policies or arrangements involving compensation:

a. Vacation policy (generally, exempt from 409A);
b. Reduction in force policies;
c. Tax gross-up commitments; and
d. Taxable reimbursement arrangements.

Split-dollar life insurance arrangements.

457(f) deferred compensation arrangements.

"Back-to-back" private equity deferral arrangements.

Corporate transaction "earn-out" arrangements.

Foreign retirement arrangements covering U.S. employees.

In addition to the arrangements specifically noted above, many bonus, equity, employment, separation, fringe benefit, tax gross-ups, expatriate allowances, earn-outs, foreign retirement and other deferred compensation arrangements may be structured to be exempt from 409A.

This list is intended to provide a representative sample of arrangements that should be reviewed for 409A purposes. It is not exhaustive, and there may be other arrangements that need to be reviewed for 409A purposes.

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