

Code Sec. 409A Rules for Nonqualified Deferred Compensation (NQDC)

The IRS has released the latest deadlines for compliance with the Code Sec. 409A rules for nonqualified deferred compensation (NQDC) plans and you need to know what action is now required.

Code Sec. 409A imposes strict requirements on NQDC plans. These requirements generally apply for: (1) amounts deferred in tax years beginning after 2004; and (2) amounts deferred in tax years beginning before 2005 if the NQDC plan is materially modified after Oct. 3, 2004.

Compliance deadlines are Dec. 31, 2008. Although IRS regulations on Code Sec. 409A were finalized in April 2007, compliance with those regulations isn't required until Jan. 1, 2009. In the interim, NQDC plans must be operated in reasonable, good-faith compliance with Code Sec. 409A and the earlier IRS guidance. By Dec. 31, 2008, plans must be amended to conform to Code Sec. 409A and the final regulations.

A similar deadline applies to changes in payment elections. A NQDC plan may provide, or be amended to provide, for new payment elections on or before Dec. 31, 2008, for both the time and form of payment. If the amendment and election are made before Jan. 1, 2009, they won't violate the rules against changes in the time or form of payment or acceleration of payments.

However, there are limits to this flexibility. An election made in 2008 can apply only to amounts that wouldn't otherwise be payable in 2008. Therefore, if a deferred amount is payable in 2008, an employee can't defer it to a later year. The employee can only defer it from one post-2008 year to another, say from 2009 to 2010.

Also, an election in 2008 may not cause an amount to be paid in 2008 that wouldn't otherwise be payable in 2008. Thus, an employee can't accelerate into 2008 an amount that is payable after 2008. An acceleration is only permissible from one post-2008 year to another, for example from 2010 to 2009.

There's also a Dec. 31, 2008, deadline for substitutions of stock rights. As explained below, non-discounted stock options and stock appreciation rights (SARs) are generally excluded from Code Sec. 409A. Until the end of 2008, non-discounted stock options and SARs can be substituted for discounted ones. However, this substitution can't be made for discounted stock rights granted to certain executives and officers if the expense wasn't timely reported on the company's financial statements.

Identifying plans that are subject to Code Sec. 409A. In order to comply with Code Sec. 409A, employers must first examine all of their compensation plans to determine whether they involve deferred compensation. A plan provides for deferral of compensation if the employee has a legally binding right to compensation that is payable in a later tax year.

Certain plans enjoy an exemption from the Code Sec. 409A requirements. Qualified retirement plans, tax-deferred annuities, simplified employee pensions (SEPs), and SIMPLE retirement accounts aren't considered NQDC plans. Code Sec. 409A also doesn't apply to some welfare benefit plans, such as bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans. Severance pay plans may be subject to Code Sec. 409A, unless an exemption applies.

There's also an exception for short-term deferrals. Under this rule, there's no



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deferral of compensation if the employee receives the compensation by 2 1/2 months after the end of the tax year of the employer or employee, whichever is later, in which the amount is no longer subject to a substantial risk of forfeiture. For example, if a calendar-year employer awards a bonus on November 1, there's no deferral of compensation if the bonus is paid or made available to the employee by the next March 15.

Non-statutory stock options (NSOs) and SARs on employer stock don't provide for deferral of compensation if the option or SAR isn't "in the money" on the date of grant and there's no other feature for deferral of compensation. The final regs liberalize the definition of stock that may be used for this purpose, and provide rules for determining the fair market value of the stock. Caution should be exercised since the presumption of fair market value is lost if there is not a qualifying appraisal performed. The final regs also allow longer extensions of the exercise period of stock options and SARs.

How to comply with Code Sec. 409A.

If it's determined that Code Sec. 409A applies to a plan, the next step is to make sure that the plan complies with the Code Sec. 409A requirements. The costs of noncompliance are high. All amounts deferred under a noncompliant NQDC plan are included in the employee's income. Interest is also imposed on that income at a rate one percentage point higher than the interest rate on tax underpayments. On top of that, a 20% penalty is imposed. While these sanctions fall on the employee, their impact will be felt by the employer, either through a formal indemnification agreement or through employee dissatisfaction.

There are four general requirements in Code Sec. 409A that relate to: (1) the initial deferral election, (2) the timing of payments, (3) acceleration of payments, and (4) later deferral elections. Each of

these requirements must be spelled out in the plan document, and the plan must be operated in accordance with them.

Initial deferral elections. In general, an employee must make the initial election to defer compensation before the year in which the services are performed. In an employee's first year of eligibility, he may make a deferral election in the first 30 days of participation, but the election may apply only to compensation earned after the election was made. An election to defer performance-based compensation that is based on services performed over 12 months or more must be made no later than six months before the end of the performance period.

Timing of payments. Payments under a NQDC plan must be made at a fixed date, under a fixed schedule, or upon any of these five events: separation from service, death, disability, change in ownership or control of the corporation, or unforeseeable emergency. If the timing of payment is based on a specified event, the plan must designate an objectively determinable date or year after the event on which payment is to be made. This rule prohibits "haircut" provisions, under which a participant may take payments at any time, subject to a reduction in amount.

Anti-acceleration rule. Payments of deferred compensation generally may not be accelerated. IRS has provided exceptions to this rule, such as for payments necessary to comply with a domestic relations order, payments necessary to comply with conflict-of-interest rules, and for certain payments when plans are terminated. IRS may allow other exceptions.

Later deferral elections. If a NQDC plan permits an employee to elect to delay or change the form of a payment, the following conditions must be met:

1. the election may not take effect until at least 12 months after the date on which it was made;

2. if the election relates to a payment that isn't on account of death, disability or unforeseeable emergency, the first payment for which the election is made must be deferred for at least five years; and
3. any election related to a payment at a specified time or under a fixed schedule may not be made less than 12 months before the date of the first scheduled payment.

Action steps to take now. In the time that remains before compliance with the final regulations are required, we must finalize any changes to your deferred compensation plans that are required to comply with Code Sec. 409A and make sure that those changes are properly reflected in the plan documents. We must also make sure that the plans will be operated in accordance with the Code Sec. 409A requirements. Finally, we must obtain any new payment elections from plan participants and make any substitutions of stock options and SAR's that are permitted under the transitional rules.

If you have any questions, please contact Cecelia Hill at 256-533-1720 or chill@beasonnalley.com.

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