

## Deferred Compensation Plans, Severance Agreements and Other Deferral Arrangements Require Immediate Attention, Despite IRS Relief

The American Jobs Creation Act introduced new restrictions on a broad array of deferred compensation arrangements by adding Section 409A to the Internal Revenue Code. All types of nonqualified deferred compensation plans and most other income deferral arrangements, including employment and severance contracts, are affected. Last week, the Internal Revenue Service issued Notice 2007-78 which extends the deadline for full amendment of all deferred compensation arrangements until December 31, 2008, with two important caveats:

- First, all deferred compensation arrangements must specify in writing the time and form of payment in a manner that complies with Section 409A by December 31, 2007; and
- Second, all deferred compensation arrangements must comply, in operation, with the final regulations under Section 409A after December 31, 2007. (Compliance under the more lenient “good faith” standard has been required since January 1, 2005.)

Accordingly, all key decisions with respect to the operation of nonqualified arrangements must be made and implemented by December 31, 2007.

We would be pleased to assist you in updating your plans and contracts in compliance with the new rules. If you would like our assistance, we ask that you send us any deferred compensation plans or other deferral arrangements (described below) by **October 15, 2007** to ensure our ability to complete your updates in a timely manner.

### Key Provisions

In general, Section 409A applies to compensation to which an employee has a legally binding right in one year but does not actually or constructively receive until another year. Section 409A is effective with respect to amounts deferred in taxable years beginning after December 31, 2004. Section 409A also applies to amounts deferred in taxable years beginning before January 1, 2005 under a plan if the plan is materially modified after October 3, 2004. The classic example of deferred compensation is a plan under which an executive defers a percentage of compensation earned in one year to be paid to him or her in a later year. Other amounts, such as bonuses, can be considered deferred compensation even though the amount of the payment (if any) is uncertain.

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This update was prepared by **Barbara Uberti Manerchia** of our **Employee Benefits and Executive Compensation Group**.

1313 North Market Street

P.O. Box 951

Wilmington, DE 19899-0951

(302) 984-6000

[www.potteranderson.com](http://www.potteranderson.com)

Unless an exception is available, the following restrictions apply to all deferred compensation arrangements under Section 409A:

- The initial election to defer compensation for a year must be made before the first day of the year in which the services are performed, or for the first year of eligibility, within 30 days of eligibility. The initial election to defer compensation must set forth the form of payment (for example, lump sum payment or installments).
- For performance-based compensation, the election to defer compensation must be made no later than six months in advance of the end of the performance period.
- The deferred compensation must be payable at a specified time or event. These times and events are limited to disability, death, separation from service, change of control, unforeseeable emergency or pursuant to a fixed schedule.
- Additional deferrals of the time of payment and changes to the form of payment of compensation are limited. Acceleration of the payment of compensation is virtually prohibited.
- Payments to a key employee of a public company upon separation from service must be delayed for a minimum of six months after the separation from service.

Some plans will require significant amendment while others will require only minor additions or revisions.

A breach of Section 409A triggers reporting requirements for employers. More significantly, failure to satisfy 409A results in the following severe tax consequences to employees:

- Income tax is due on the amount deferred in the year in which the compensation is earned and vested (without regard to whether the employee could have received the compensation in that year); plus
- Additional tax is due in the amount of 20% of the amount deferred; plus
- Interest is due on the tax liability at the underpayment rate plus 1%.

### Checklist of Plans and Arrangements

With limited exceptions, the following plans ARE subject to 409A:

- Deferred compensation plans, incentive plans and bonus arrangements
- Excess benefit plans (including supplemental defined benefit plans and supplemental defined contribution plans, sometimes called “piggy-back” plans)
- Severance pay plans and individual severance contracts
- Employment agreements that provide for a deferral of compensation or severance pay
- Change of control agreements

All affected plans must specify in writing the time and form of payment in a manner that complies with Section 409A by December 31, 2007 and be operated in compliance with the final regulations under Section 409A after December 31, 2007.

- Rabbi trusts or other agreements under which funding is triggered by a change in connection with the employer's financial health
- Phantom stock plans
- Stock appreciation rights plans
- Discounted stock options
- Restricted stock plans
- Settlement agreements, indemnification agreements and retiree medical agreements.

The following plans are NOT subject to 409A:

- Plans which at all times require payment no later than 2½ months following the close of the employer's or employee's tax year in which the right to compensation vests
- Qualified retirement plans (such as 401(k) plans, defined benefit plans and ESOPs)
- Vacation programs, sick leave programs and compensatory time programs
- Disability pay and death benefit plans
- Archer medical savings accounts and health savings accounts
- Stock options granted at fair market value
- Certain foreign plans, restricted stock plans and stock appreciation rights that meet specific conditions.

### Time Is of the Essence

Some plans will require significant amendment while others will require only minor additions or revisions. Many clients are familiar with the basics of Section 409A because all nonqualified deferred compensation arrangements have been subject to the good faith compliance requirements of Section 409A for the years 2005 through 2007. **All affected plans must specify in writing the time and form of payment in a manner that complies with Section 409A by December 31, 2007, and be operated in compliance with the final regulations under Section 409A after December 31, 2007.** The terms of your plan will need to be analyzed to determine how to comply with the time and form of payment rules and, further, to comply operationally with the full scope of Section 409A requirements. We ask your help in sending us your documents as soon as possible so that we can provide you – and, if necessary, your board or compensation committee – sufficient time to understand the specific changes required to your documents and to the operation of your plans and programs.

If you have any questions, please contact any member of our Employee Benefits and Executive Compensation Group:

Barbara Uberti Manerchia  
(302) 984-6040  
bmanerchia@potteranderson.com

John J. Quinn, III  
(302) 984-6157  
jquinn@potteranderson.com

B. Janell Grenier  
(302) 984-6193  
jgrenier@potteranderson.com

Arris Reddick Murphy  
(302) 984-6183  
amurphy@potteranderson.com

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