

IRS Issues Final Section 409A Regulations – Action Required By January 1, 2008

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Overview

On April 10, 2007, the IRS issued final regulations under Section 409A of the Internal Revenue Code (the "Code"). The final regulations include a variety of changes to existing guidance regarding nonqualified deferred compensation arrangements. The final regulations are effective January 1, 2008 and all nonqualified deferred compensation arrangements must be amended to comply with Section 409A and the final regulations by January 1, 2008. Prior to January 1, 2008, nonqualified deferred compensation arrangements must be operated in good faith compliance with the Section 409A and all guidance issued to date, including the final regulations. Given the January 1, 2008 deadline, employers should address the impact of the final regulations on existing nonqualified deferred compensation arrangements as soon as possible.

Background

The American Jobs Creation Act of 2004 was passed by Congress on October 11, 2004. This legislation added Section 409A to the Code, which significantly changed the tax rules applicable to nonqualified deferred compensation arrangements. A violation of Section 409A will result in current taxation on the deferred compensation for the affected participant, plus an additional 20% tax on the taxable amount, and interest. Section 409A generally applies to amounts deferred after December 31, 2004. Proposed regulations were issued in October 2005 and the IRS and Treasury Department have issued six notices that provide guidance regarding transitional compliance with Section 409A.

The Final Regulations

One of the most significant features of the final regulations is that they maintain the December 31, 2007 deadline for amendment of all deferred compensation arrangements to comply with Section 409A. In general, the final regulations incorporate the rules included in the proposed regulations and provide clarification and examples designed to illustrate the application of Section 409A.

Highlights of the final regulations include:

- Severance payments made upon "good reason" terminations may, in certain cases, be treated as payments made upon involuntary separation and therefore eligible for an exemption from the Section 409A rules. The final regulations include a safe-harbor definition of "good reason" that employers may want to consider using in employment and similar agreements.
- The exercise period for a stock option or stock appreciation right may be extended to its original maximum term or 10 years from the original date of grant, whichever is shorter, without triggering Section 409A. Additional relief is granted if the option is underwater at the time of the extension. The definition of service recipient stock is expanded to include any class of common stock. Awards granted before April 10, 2007 are not required to conform to the new rules, provided they were granted in good faith, reasonable reliance on prior guidance.
- The exemption from Section 409A for short-term deferrals is further limited. If an arrangement is intended to be exempt as a short-term deferral arrangement, the written document must specify that payment will be made not later than two and a half months after the end of the taxable year of the employee in which the employee's right to the compensation is no longer subject to a substantial risk of forfeiture.
- The definition of deferral of compensation is modified to provide that a deferral will occur if pursuant to the term of the deferred compensation plan, compensation is "or may be" deferred to a later taxable year.
- The rules applicable to aggregation of plans, reimbursement arrangements, separation from service, severance pay, payment events and grandfathered amounts are liberalized.
- Clarification is provided with respect to deferral elections, permissible accelerations, subsequent elections and linked plan elections.

The final regulations do not contain guidance on the application of Section 409A to equity interests in non-corporate entities such as partnerships, or any guidance as to how to calculate the amount to be included in income if an arrangements fails to comply with Section 409A.

Action Required

All nonqualified deferred compensation arrangements should be reviewed and amended to comply with the final regulations. The deadline for any necessary amendments is December 31, 2007.

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