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I.R.C. Section 409A – Highlights and Pitfalls

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Today's Presentation

- Overview of Final Regulations Issued under § 409A
 - Expansive Definition of Deferred Compensation
 - Focus on Most Common Pitfalls
 - Penalties for Noncompliance

Also: Executive Compensation and the Change of Control Event: Why not to lose sight of executive compensation issues in determining purchase price.

Key Components of Section 409A

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- Penalties for Noncompliance
- Definition of Deferred Compensation
- Transition Period
- Deferral Election Rules
- Distribution Rules
- Reporting Requirements

Penalties

Penalties

When 409A is violated, the penalties include:

- (1) taxation of vested amounts; plus
- (2) a 20% additional tax; and
- (3) interest at the IRS “late payment” rate plus 1%, calculated as if there were tax underpayments in the year when deferrals first occurred, or were first vested, if later.

Penalties

- A plan failure unique to one individual will not penalize other plan participants. However, if there is a plan failure, the penalty is assessed for all of the participant's vested benefits in all 409A plans of the same type.

What is Deferred Compensation?

Scope of Section 409A

- Definition: Section 409A generally provides that a deferral of compensation occurs if a service provider has a legally binding right during a year to compensation that is or may be payable to the service provider in a later year.

Scope of Section 409A

- Exclusions: The final regulations exclude the following from coverage under Section 409A:
 - Qualified plans (401(k), 403(b), 415(m), 457(b))
 - Bona fide sick leave or vacation plan
 - Disability plan
 - Death benefit plan
 - Certain other medical reimbursement arrangements
- In addition, there are other broad exemptions, for example, for grants of restricted property.

Scope of Section 409A

- Other specific exemptions include:
 - Severance pay
 - FMV stock options and SARs
 - Short-term deferrals

Severance Pay and Post-Employment Benefits

- Limited to two times pay
- Only involuntary terminations (includes constructive terminations)
- Other post-employment benefits
 - Business expense reimbursements
 - Medical expenses
 - Provision of in-kind benefits (i.e. office space)
 - Moving and relocation payments
 - Outplacement expenses

Stock Rights: Options and SARs

- Nonqualified stock options and stock appreciation rights (“SARS”) are exempt from coverage under Section 409A provided:
 - The stock right is granted for not less than fair market value of the underlying stock at the date of grant;
 - The stock right does not include any feature for the deferral of compensation; and
 - The number of shares covered by the grant are fixed on the grant date.

“Short-term Deferral” Exemption

- A deferral of compensation does not occur under a plan if:
 - absent an election to defer a payment to a later period
 - the amount is actually or constructively received by an employee by the end of the applicable 2 ½ month period.

Split-Dollar Life Insurance

- Generally, split-dollar arrangements that provide for deferred compensation will be subject to section 409A.
- However, arrangements that provide only death benefits to the employee, or that provide a legally binding right to amounts that are included in income in accordance with the short-term deferral exception, are not subject to section 409A.

Plan Aggregation

- All plans of a similar type (e.g., account balance plans) would be aggregated and treated as one plan for certain purposes under section 409A.

Transition Period

Transition Period

- Notice 2005-1 was issued in December 2004 and provided that a plan would not be treated as violating the requirements of Section 409A if:
 - the plan was operated in good faith compliance with the provisions of the statute of guidance issues by the IRS; and
 - the plan was amended by December 31, 2005 to conform to the provisions of Section 409A
- **Recent notices have extended good faith compliance period to December 31, 2008**

Key Areas of Concern

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- Distribution events
- Timing of deferrals
- Acceleration / Postponement of payments
- Plan terminations
- Written Plan Requirement

Distributions

- Distribution is only allowed for certain events, including:
 - At a Specific Date or according to a Fixed Schedule
 - Separation from Service
 - Disability
 - Death
 - An Unforeseeable Emergency
 - At a Change of Control

Deferral Elections

- Deferral elections must comply with initial timing rules.
- They must be made before the start of the tax year in which services will be performed.
- New participants may make deferral elections within the 30 days following initial eligibility.
- In the case of bonuses under performance-based plans, the election must be made no later than 6 months before the end of the service period (i.e. by June 30, 2005 for a 2006 bonus payable for 2005 services).

Deferral Elections

- No acceleration of the time or schedule for payments will not be permitted **except**:
 - A change to a deferral payment date is made at least 12 months prior to the scheduled payment, and the change postpones the payment for at least 5 years from the date the payment was originally scheduled;
- No postponement of payment date or changes in form of distribution.

Distributions on Plan Termination

Plan termination may cause impermissible acceleration, unless:

- the termination does not occur proximate to a downturn in the financial health of the employer;
- all plans of the same type maintained by the employer (e.g., all elective account balance plans) are terminated with respect to all participants;
- no payments are made within 12 months of the plan termination;

Distributions on Plan Termination

- all payments are made within 24 months of the plan termination; and
- the employer does not adopt a plan of the same type for a period of 3 years following the date of plan termination.

Written Plan Requirements

- May be in more than one document
- Must include payment amounts (or formula to calculate payment amounts) and form of payment
- Must set forth the conditions under which deferral elections (and subsequent deferral elections) may be made
- Must contain the six-month delay rule on payment to key employees of public companies
- All Plans must be brought into compliance by the end of 2008.

Reporting Requirements

Reporting Requirements

- 409A requires the reporting of deferred compensation not yet includible in income as well as amounts includible income on Forms W-2 and 1099-MISC;
- Reporting requirement is suspended until 2008

Notice 2007-89

- Notice 2007-89 (issued October 23, 2007) provides guidance on:
 - reporting and withholding compensation that is deferred in 2007,
 - reporting and withholding amounts includible in income under section 409A in 2007, and
 - income tax reporting and tax payment for amounts includible in income under 409A in 2007.

Notice 2007-89

- Amounts reportable under 409A are determined in the following ways:
 - All compensation deferred under a plan that as of December 31, 2007 is no longer subject to substantial risk of forfeiture is includible in income to the extent that such amounts have not previously been included in income.
 - All compensation deferred under a plan that is remains subject to a substantial risk of forfeiture, and where the amount deferred is reasonably ascertainable, the amount deferred as of December 31, 2007 equals the present value of all future payments to which the employee or service provider has a legally binding right on December 31, 2007.

Notice 2007-89

- An amount is reasonably ascertainable when the amount, form, and commencement date of the benefit payments are known. If these facts are known, the existence of alternative forms of payments will not make a payment not reasonably ascertainable.

Reporting Requirements: Employer Prospective

- Section 3401 of the Code treats amounts includible in income under 409A as “wages.” An employer must report amounts includible in income as wages for income tax withholding on line 2 of Form 941.
- For purposes of calculating the amount of income tax required to be deducted and withheld, amounts includible in income for 2007 under 409A are supplemental wages regardless of whether regular wages are paid during the calendar year. Accordingly, estimated tax payments may be required to avoid penalties under section 6654 of the Code.

Reporting Requirements: Employer Prospective

- Amounts includible in gross income under 409A in 2007 that are actually or constructively received by an employee during 2007 are considered paid when received by the employee for purposes of withholding, depositing, and reporting the income under section 3401(a) of the Code.
- Amounts that are neither actually nor constructively received (i.e., imputed income) are treated as paid on December 31, 2007.

Other Areas of Concern

Section 409A and the Tax-Exempt Employer

- Section 457(b) Plan Exempt
- Section 457(f) Plans Are Subject to 409A as well as general rules under 457(f)
 - No rolling risks of forfeiture
 - Entire amount includible in income the year in which it is no longer subject to a substantial risk of forfeiture

Grandfathered Amounts/Material Modifications

- Amounts deferred and vested before 2005 are not subject to section 409A unless the plan under which the compensation is deferred is materially modified on or after October 3, 2004.
- Generally, a plan is materially modified if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added.

Executive Compensation and the Change of Control Event

The economic impact of seemingly innocuous executive compensation plans
when your client buys or sells a business

Due Diligence

- Necessary to Determining Hidden or Contingent Liabilities. Important to:
 - Effectively negotiate reps and warranties.
 - Develop appropriate indemnification provisions and coordinate with overall indemnification basket used in transaction.
 - Negotiate any appropriate adjustment to purchase price; escrow portion of purchase price pending resolution of issues/audits; or offset installment payments of purchase price.

Where to Look

- Employment Agreements
- Severance Agreements
- Change of Control Agreements
- Minutes of Board of Directors meetings
- Top Hat Plan
 - SERPs
 - Bonus Plans
- Elective Deferral Plans
- Split-dollar Life Insurance arrangements
- Phantom Stock/Stock Appreciation Rights Plans
- Stock Options

Why it Matters

- Many Agreements include payments upon a Change of Control
- 409A requires that such payments may not be postponed or substituted
- NQDC Plan are often unfunded and do not appear on the financial statements
- In CNY Market, these hidden liabilities can make a difference

Don't Forget about the Qualified Plans

- Liabilities that may not be on the financial statements:
 - Qualified Plan Failure Penalties
 - Past Due Plan Distributions
 - Under-funded defined benefit plans
 - ESOP Put Option requirements
 - Promises to Provide Welfare Plan benefits through COBRA period or beyond
 - Multiemployer withdrawal liability
 - Vacation Pay liabilities



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