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IRS Requires Action Before Year-End On 409A Deferred Compensation Arrangements

December 2007

As many company executives are aware, the United States Treasury Department issued final regulations this year under 409A of the Internal Revenue Code. Section 409A governs the treatment of deferred compensation arrangements that companies offer to executives, employees, directors, and independent contractors. The companies can be private, public, or even tax-exempt. The effective date for 409A and its regulations is January 1, 2008. You must act now to ensure compliance by then.

409A Affects Which Arrangements?

Section 409A affects companies and persons who are parties to an agreement where a person has a "legally binding right" *in a current year* to cash, reimbursements, or in-kind services that the company will pay *in a later year*.

These deferred compensation arrangements include, but are not limited to, the following:

- Employment agreements with severance and separation-pay provisions;
- Change-in-control provisions;
- Annual and multi-year bonus plans;
- Reimbursement arrangements;
- Discounted stock option plans; and
- Phantom plans.

Why Does 409A Matter?

IRS Imposes Taxes Earlier. Generally, if these arrangements do not comply with 409A, then persons with these faulty arrangements could pay federal income and excise tax rates up to 55% (plus interest) on amounts those persons had expected to pay *lower* tax and to pay only in *later* years. State taxes would also apply to this income earlier, rather than later.

IRS Imposes Additional Burdens on Companies. Companies with non-compliant arrangements will have additional IRS reporting and withholding obligations. Persons holding non-compliant 409A arrangements will likely seek redress from the companies who drafted such arrangements should the IRS unexpectedly (but appropriately) tax them. After all, these persons were expecting to defer and not incur current taxation. Certainly, these persons do not expect to pay penalties.

IRS Requires Action Before Year-End On 409A Deferred Compensation Arrangements,

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What To Do Before The End Of 2007?

Inventory and Identify 409A Arrangements. Companies, and those persons who have deferred compensation agreements, should inventory and identify all agreements that have 409A concerns.

Draft Arrangements to Conform to 409A. Companies *have to* -- and persons who are a party to these arrangements *must demand* that the companies who will pay their deferred compensation -- amend the arrangements so as to be in writing, with the recipient clearly identified, the amount of compensation established, and the time and form of payment specifically defined -- all consistent with 409A.

Help For 409a Arrangements . . . With Inventory And Drafting?

Contact the Chamberlain Hrdlicka Employee Benefits Group. The 409A rules are difficult to navigate and interpret, with respect to deferred compensation. You can contact us toll-free at 1.800.342.5829, or:

- Call Stephen M. Mason and Jerome M. Harris at (713) 658-1818; or
- Call Jewell Lim Esposito and Rebecca Jordan Manners at (610) 772-2300.