

LABOR AND EMPLOYMENT LAW UPDATE



ARE YOU READY FOR JANUARY 1, 2008? PART I: THE NONQUALIFIED DEFERRED COMPENSATION REGULATIONS

As part of the continuing fallout from the Enron and other corporate scandals, the IRS recently adopted final regulations regarding Section 409A of the Internal Revenue Code, which governs the taxation of deferred compensation for “service providers.” An IRS official has said that Section 409A marks a “sea change” in deferred compensation; the breadth of the new regulations shows this statement was an understatement.

WHOSE COMPENSATION IS AFFECTED?

Section 409A governs compensation to “service providers” who are broadly defined as individuals and *entities* that provide services. Although bona fide independent contractors are excluded by the statute, the following are among those included:

- * Directors
- * Officers
- * Employees
- * Some consultants

WHAT IS A DEFERRED COMPENSATION PLAN?

A plan provides for the deferral of compensation if, under its terms and relevant circumstances, a service provider has a legally binding right to compensation that, pursuant to its terms, is or *may be* payable in a later tax year. Compensation may be in any form having value, such as equity interests.

WHAT ARRANGEMENTS ARE AFFECTED?

Some obvious compensation arrangements, amongst others, that are impacted by the new regulations are:

- * Supplemental Executive Retirement Plans (SERP)
- * Account balance plans
- * Deferred or deferrable stock rights
- * 401(k) wrap plans.
- * Split-dollar life insurance plans

Less obvious arrangements also potentially impacted by Section 409A, however, are:

- * Severance pay in employment agreements, benefit plans and separation agreements
- * Legal settlements not based upon “bona fide” claims
- * Voluntary retirement programs.

WHAT HAS CHANGED? Section 409A generally provides that, unless certain requirements are met, all amounts deferred under a deferred compensation plan which are not subject to a substantial risk of forfeiture must be included in a recipient’s *current* gross income for tax purposes.

WHAT ARE THE STAKES FOR RECIPIENTS OF DEFERRED COMPENSATION? The tax consequences of a deferred compensation plan which does not comply with Section 409A are borne entirely by the recipient. The recipient can be subjected to income taxes *before* compensation is received *plus* interest and a 20% penalty. For highly compensated individuals, this financial toll can be substantial.

WHAT ARE THE STAKES FOR PROVIDERS OF DEFERRED COMPENSATION? Disgruntled recipients forced to pay harsh taxes and penalties under a flawed deferred compensation plan will likely turn to plan providers for answers and money. Suits alleging a variety of claims are unavoidable. Companies will not be the only defendants in such suits; individuals who design, recommend, approve or administer flawed plans will also likely be sued.

WHAT IS REQUIRED UNDER THE NEW REGULATIONS? To avoid taxation and penalties, deferred compensation plans must condition future payment upon fixed dates or events. Generally, acceleration of payment is impermissible. The only permitted payment dates and events are:

- * The recipient's separation from service
- * The recipient's disability
- * The recipient's death
- * A time or fixed schedule
- * A change in ownership
- * An unforeseeable emergency

ARE THERE ADDITIONAL REQUIREMENTS FOR PUBLIC COMPANIES? Yes. For instance, severance pay to "key employees" cannot commence until 6 months and a day after separation.

ARE THERE EXEMPTIONS? Yes. Although too numerous to list here, there are exemptions to the Section 409A requirements. Certain arrangements, such as qualified retirement plans, welfare plans and collective bargaining agreements are completely exempted. Other arrangements, including those which provide severance pay, are exempt only if they contain certain provisions.

WHAT ABOUT OLDER DEFERRED COMPENSATION PLANS? Deferred compensation which was vested or deferred before December 31, 2004 is not affected by Section 409A as long as the plan under which the compensation was granted was not materially modified after October 3, 2004.

CAN EXISTING DEFERRED COMPENSATION PLANS BE FIXED OR AMENDED? Many existing plans can be amended to bring them in compliance with Section 409A. The catch is that these amendments *must be completed by December 31, 2007*. On January 1, 2008, taxes and penalties will ensue for non-conforming plans.

WHAT IS RECOMMENDED FOR PROVIDERS OF DEFERRED COMPENSATION PLANS? Act now. Arrangements with service providers should be reviewed with legal counsel to determine whether they are subject to Section 409A. If so, an action plan should be devised and implemented, with the assistance of legal counsel, to ensure timely compliance.

PREVIEW: Part II of this presentation, entitled "What Looms Beyond January 1, 2008?", will be distributed later this month. Part II will explore in greater depth the gravity of the stakes presented by Section 409A as well as a list of persons who should be concerned about the IRS regulations.

ADDITIONAL QUESTIONS? If you have any questions about Section 409A or the new IRS regulations, please contact Robert Chadwick or Bruce Campbell at Campbell & LeBoeuf, P.C.

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