



Don't Hand Your Employees a Lump of Coal This Holiday Season!

By Greg Nichols (Tampa)

Many employers are now beginning their compensation planning for 2009. But this year, unlike others, brings a new holiday treat, namely required *full compliance* with Section 409A of the Internal Revenue Code which places significant limitations and conditions on so-called “deferred compensation” plans and agreements.

Due to the expansive nature of Section 409A, and its *almost 400 pages* of implementing regulations, there are any number of potential pitfalls you must navigate. At the very least, you will need to review and perhaps amend every traditional deferred compensation plan (along with employment and severance agreements, as well as bonus programs) before December 31st to make sure they are in full operational, administrative and documentary compliance beginning January 1, 2009.

What Is Section 409A?

Section 409A of the Code applies generally to nonqualified “deferred compensation” plans and permits your employees or service providers to defer income – subject to very specific conditions related to the election, timing and distribution of benefits. Although it sounds pretty straight-forward, it is anything but.

In addition to traditional deferred compensation plans, Section 409A can apply to a wide range of plans, agreements, practices or arrangements that are common to most employers such as severance, separation, change of control and employment agreements, as well as bonus and equity plans. In other words, virtually any arrangement that deals with the timing and form of payment is potentially covered by 409A.

The regulations are not necessarily new since they were originally issued in proposed form in October 2005 and final form in April 2007. The IRS provided transition periods to allow employers sufficient time to understand the implications of 409A and to take the steps necessary to fully comply. Employers, employees and service providers could avoid running afoul of section 409A so long as certain good faith reliance and compliance standards were met. But the last transition period ends December 31, 2008.

Who and What Is Covered?

Traditional deferred compensation plans used to be the exclusive province of senior management and top executives. Such plans were typically designed to allow participants to make an advance, irrevocable election to defer receipt of a portion of their compensation to some future

date, to the extent that the applicable compensation was subsequently earned.

Similar to pension or other retirement benefit plans, and depending on the plan design elements, which have always included amount and timing requirements, the deferred compensation could grow during the deferral period. The value of the participant’s deferral account would be paid in a lump-sum or series of payments once the participant separated from service with the employer. There were and still are a multitude of plan designs, funding mechanisms, payment schemes and the like, all of which are beyond the general scope of this article.

But 409A changed the rules of the road. Now almost any of your employees can find themselves covered by a deferred compensation plan, arrangement or practice. Likewise, because the coverage of 409A extends to big and small, private and publicly traded companies as well as not-for-profit organizations, almost any employer can find that it has created or sponsored, sometimes unwittingly, a deferred compensation plan.

Making A List, And Checking It Twice

Many employers simply do not believe that they have a nonqualified deferred compensation plan – let alone more than one. But the likelihood is that you do. For example, if you answer “yes” to *any* of the following questions, the final regulations may very well apply to your employees and organization.

For starters, does any employee have

- a written employment contract or agreement?
- an offer letter that spells out how the individual will be paid over time?
- an agreement or arrangement to receive future benefits?
- discretion as to the timing of compensation whether under a written agreement or not?
- the right to terminate their employment for ‘good reason’ and receive severance pay?
- an agreement by which they perform consulting services after the expiration of their employment?
- a change of control agreement?
- post-employment rights to any form of benefits or compensation?
- post-employment rights to compensation depending on how their separation is classified?



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But wait! There's more! Does your company

- retain or exercise its discretion to decide when certain compensation is paid?
- pay bonuses in the year after the year in which they are earned?
- award equity grants in any form including common stock, phantom stock or stock appreciation rights?
- have a collectively bargained severance agreement?
- have any compensation arrangement where the time and form of payment is linked to a tax qualified plan?
- have a SERP (supplemental executive retirement plan) or any other excess benefit plan?

And a bonus question: has anyone received termination pay more than 2 1/2 months after a separation of service whether under a written agreement or not?

These are only samples of the type of questions you need to be asking to ensure that all plans, practices and arrangements are brought into compliance on or before December 31.

Why Should I Care about 409A?

Can you say employee-relations nightmare?

Although the employer is responsible for withholding and reporting taxes, the penalty for noncompliance is primarily borne by the participant to the tune of *immediate taxation on the full amount deferred PLUS an additional 20% tax – Bah Humbug!*

And if that isn't enough, some states impose additional tax obligations under state law. Just imagine explaining to your CEO that her retirement planning has been dashed by the negative and unintended tax consequences of your failure to review and amend certain plans or agreements....Enough said.

In addition, if you find that you have agreements that are covered by 409A, you must take steps to amend the agreements which necessarily means getting the agreement of the affected employee. Clearly, this can lead to the negotiation of other terms of employment if the modifications

to the preexisting agreement are substantial or materially alter the original compensation structure. Of course, some employees will want to renegotiate terms whether the 409A issues are material or not.

And in the case of a publicly-traded company, the compensation committee and/or board of directors will generally need to approve changes to the compensation arrangements between the company and its CEO as well as other named executive officers and make the appropriate public filings.

Is There Any Relief?

Not wanting to be a complete Grinch, the IRS provides a number of exceptions, exclusions and safe harbors that many employers will find helpful. For example, subject to certain conditions, payments made before 2 1/2 months after the end of the taxable year of the service provider in which a substantial risk of forfeiture lapses are exempt from 409A. Subject to amount, time and form conditions, the regulations also provide a safe harbor for payments made solely in connection with an involuntary separation from service and the criteria that must be met to qualify a termination for 'good reason' as an involuntary termination. And finally, the regulations do not apply to tax qualified plans such as 401(k) and 403(b) plans.

What Should I Be Doing?

To avoid being Scrooged, the first thing you should do is review any and all plans, agreements, contracts, arrangements, practices and understandings that deal in any way with the timing and form of employee/service provider compensation. The assistance of competent counsel will help speed the process.

It's important for employers to comply with the requirements of 409A to avoid inadvertently giving employees a proverbial "lump of coal" this holiday season in the form of a substantial and unintended tax liability. With proper legal guidance, careful planning, and good communications, you should be able to comply with 409A by January 1.

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New Secondary Payer Reporting Requirements Take Effect January 1, 2009

By Callan Carter (San Francisco)

The Medicare, Medicaid, and SCHIP Extension Act of 2007 requires health insurers and third-party administrators (TPAs) to submit data to the Centers for Medicare and Medicaid Services (CMS) identifying situations where the group health plan is secondary to Medicare. Effective January 1, 2009, certain data elements must be reported to CMS on a quarterly basis. The penalty for failing to report the required data elements is \$1,000 per person per day for which the data should have been submitted.

Group health plans that are currently participating in CMS's voluntary data-sharing program will have little additional compliance responsibility related to the new mandatory reporting. But the data collection and reporting process may be significant for group health plans not currently participating in CMS's voluntary data-sharing program due to the detail of data required to be reported.

Insurers and TPAs must identify, collect, and submit data on all Medicare-eligible participants. This will require cooperation between the plan sponsor and the insurance company or TPA. Plan Sponsors should be aware that your TPAs may also increase their administrative fees as a result of the quarterly reporting and its recordkeeping requirements and may seek indemnification for any reporting failures.

Our advice to plan sponsors: request written assurances from your group health plan insurers and TPAs confirming that they will assume responsibility for the data collection and reporting process.

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