

EMPLOYEE BENEFITS ALERT

IRS ISSUES FINAL SECTION 409A REGULATIONS CLARIFYING TREATMENT OF NONQUALIFIED DEFERRED COMPENSATION



On April 10, 2007, the Treasury Department and the Internal Revenue Service issued final regulations <http://www.akingump.com/docs/publication/968.pdf> under Internal Revenue Code Section 409A, the 2004 tax law that dramatically changed the tax treatment of nonqualified deferred compensation. The final regulations are generally effective January 1, 2008, and implement many of the rules provided in the proposed regulations published on September 30, 2005. The final regulations also make numerous changes and clarifications in response to comments received from the public. A number of these changes are more favorable for taxpayers than the earlier proposed regulations (e.g., the ability to extend options beyond the end of the year in which termination of employment occurs, subject to certain conditions).

Section 409A generally governs the timing of deferral elections and payments under nonqualified deferred compensation arrangements covering employees, directors and independent contractors, and tax penalties are imposed on participants for noncompliance. All nonqualified deferred compensation arrangements must be amended to comply with Section 409A and the final regulations by December 31, 2007, and good-faith compliance is still required during 2007.

In addition to traditional salary and bonus deferral arrangements and supplemental executive retirement plans, arrangements subject to Section 409A may include employment agreements, severance and change in control agreements, certain split-dollar life insurance arrangements, phantom stock (including restricted stock units), and stock options and stock appreciation rights that have an exercise price below grant date fair market value.

Employers now should identify and carefully review each of these nonqualified deferred compensation arrangements to ensure that the required amendments are made by the December 31 deadline, even if amendments were made based on the proposed regulations. If a nonqualified deferred compensation arrangement is not amended by the December 31 deadline, participants in that arrangement may be subject to immediate taxation and a 20 percent penalty tax plus possible interest penalties.

The final regulations do not address the calculation and timing of amounts that must be included in income under Section 409A, the reporting and withholding requirements for employers, or the application of Section 409A to most partnership arrangements. The Treasury Department and the IRS intend to issue further guidance on these and other issues.

We intend to issue a series of additional alerts addressing specific aspects of the final regulations.

CONTACT INFORMATION

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