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# Strasburger Tax Strategies

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## IRC § 409A Requires Action on Deferred Compensation

Most readers of this *Tax Strategies Newsletter* will be aware that in late 2004 Congress enacted Internal Revenue Code ("IRC") § 409A, which imposes new federal income tax rules for nonqualified deferred compensation. The new rules generally apply whenever compensation for services is paid in a calendar year after the calendar year in which the services are performed. All companies — large and small, public and private — are potentially affected by the new rules, as are all nonprofit organizations, governmental agencies and instrumentalities, and churches. Importantly, IRC § 409A applies to many compensation arrangements that in the past have not typically been considered to be "nonqualified deferred compensation." This *Tax Strategies Newsletter* highlights some of the key features of IRC § 409A and outlines several steps that companies should take before January 1, 2009 in order to ensure compliance with the new rules.

### Scope of IRC § 409A

IRC § 409A as interpreted by Treasury and IRS contains a very expansive definition of what constitutes "nonqualified deferred compensation." Certain deferred compensation plans and arrangements are statutorily exempt from IRC § 409A. These are: qualified retirement plans (i.e., IRC §§ 401(a), 401(k), 457(b), and 403(b) plans), and vacation pay, sick pay, compensatory time off, disability, and death benefit plans and policies. All other plans and arrangements, however, that result in a person's receiving compensation for services in a calendar year after the calendar year in which the services were performed are potential grist for IRC § 409A's mill. Organizations face substantial issues under IRC § 409A if they have nonqualified deferred compensation plans, including plans for directors, supplemental or excess benefit plans, taxable post-retirement benefits (including in-kind benefits for retired



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executives), employment or severance agreements, long-term incentive plans, stock-based compensation, or agreements for the provision of management services, including investment management services.

### **Consequences of IRC § 409A Noncompliance**

IRC § 409A imposes harsh tax penalties for plans and arrangements that do not satisfy its rules. Generally, if a nonqualified deferred compensation plan or arrangement does not comply with IRC § 409A, the amount deferred will be included in the service provider's income immediately, whether or not the amount is currently payable.

Furthermore, a penalty tax of 20% will be imposed on the amount included in income, as well as an "interest" charge — calculated at the IRS interest rate for tax underpayments plus one percent — for the period from the date when the amount was first deferred to the date when it is includable in income.

### **IRC § 409A Requirements**

Generally, the requirements of IRC § 409A fall into three areas: (1) limitations on when a service provider may elect to defer compensation, if the service provider has the choice whether to defer or not; (2) limitations on when deferred compensation may be paid; and (3) limitations on when a change may be made to the payment date for nonqualified deferred compensation. IRC § 409A also generally prohibits funding of nonqualified deferred compensation with offshore trusts or other offshore security devices, or with trusts or other security devices that have "financial health" triggers.

### **Impact of IRC § 409A Final Regulations**

Although IRC § 409A was effective January 1, 2005, the requirement for full compliance was effectively postponed by Treasury and IRS pending publication of final Treasury regulations explaining IRC § 409A's detailed requirements. Final IRC § 409A regulations were published on April 10, 2007 with a January 1, 2008 effective date, but the effective date for full compliance was postponed to January 1, 2009 by Notices 2007-78 and 2007-86. Full compliance generally means that a nonqualified deferred compensation plan or arrangement must be operated in accordance with a legally binding written document that subjects it to all the rules set forth in the IRC § 409A final regulations. In most cases, this will require amendments to, or restatements of, existing plan documents or contracts; in some cases it will require documenting previously unwritten arrangements.

Although the new rules are much less flexible than those that applied under prior law, they are generally straightforward in their application to conventional nonqualified deferred compensation plans and arrangements. However, the new rules can be highly impractical when applied to plans and arrangements that, although not traditionally viewed as “deferred compensation,” now come within the expanded scope of that term. Partly because of this, the final IRC § 409A regulations contain a myriad of policy-based exceptions that have the effect of waiving application of the new rules to many plans and arrangements, but only if all of the detailed requirements of the potentially applicable exceptions are satisfied.

### **Key Points to Consider**

You should note the following in connection with the requirements of IRC § 409A effective January 1, 2009:

- For periods after 2004 and before 2009, “good faith” compliance of a plan’s or arrangement’s actual operations with a reasonable and consistent interpretation of IRC § 409A under Treasury’s and IRS’s interim guidance is required.
- The requirements of IRC § 409A apply not only to formal plans covering a group of individuals, but also to individual deferral arrangements that are included in employment contracts, severance agreements, and bonus or other incentive plans and arrangements.
- The requirement that a plan or arrangement be reduced to an IRC § 409A-compliant writing no later than December 31, 2008 applies to all plans and arrangements, no matter how insignificant or individualized. After 2008, an unwritten agreement to defer compensation, even one that applies to only a single participant, will be deemed to violate IRC § 409A simply because it is unwritten, no matter what the parties to the arrangement may represent concerning the arrangement’s terms.
- IRC § 409A applies to nonqualified deferred compensation arrangements with employees, directors, and certain other nonemployee service providers.
- Stock options and other forms of stock-based

compensation must meet new valuation and other requirements in order to avoid treatment as nonqualified deferred compensation. Failure to meet the conditions necessary to except stock options and other stock-based compensation from nonqualified deferred compensation treatment under IRC § 409A will typically have unacceptable tax consequences.

- IRC § 409A's harsh penalties (immediate inclusion in income, 20% additional tax, and "interest" charge) fall entirely on the employee or other service provider. Therefore, an individual who, or in some cases, an organization that, is owed nonqualified deferred compensation has an important stake in making sure that the plan or arrangement under which the amount is owed complies with the new rules.
- Payors of IRC § 409A-noncompliant nonqualified deferred compensation are generally required to report, on IRS Form W-2 or 1099-MISC, the existence of the nonqualified deferred compensation and the amount of income triggered under a plan or arrangement that does not comply with IRC § 409A.

### **"Grandfathering" Available for Pre-2005 Amounts**

Generally, nonqualified deferred compensation that was vested before 2005 is not subject to IRC § 409A. Post-2004 earnings on such amounts (including post-2004 increases in present value due to mortality and interest adjustments in a defined benefit arrangement) are also generally not subject to IRC § 409A. Thus, organizations will need to determine whether they want to bring pre-2005 amounts under their new IRC § 409A-compliant plan documents or, instead, "wall off" pre-2005 amounts in a separate "grandfathered" plan.

If the pre-2005 portion of a plan or arrangement is to be kept intact as a grandfathered plan, careful drafting and accounting will generally be required. Moreover, any but the most limited post-October 3, 2004 changes to a plan or arrangement covering pre-2005 amounts could constitute a "material modification" that, under the IRC § 409A transition rules, would cause the pre-2005 amounts to become subject to IRC § 409A. Thus, the ability to "grandfather" pre-2005 deferrals can be lost if care is not taken in amending and restating plan documents and contracts.

**Recommended Action Steps** To avoid the imposition of severe tax penalties, every company, nonprofit organization, governmental entity, and church needs to take the following steps:

- Step 1: Determine who within the organization is responsible for ensuring IRC § 409A compliance.
- Step 2: Identify the outside expert on whom the organization will rely for IRC § 409A guidance.
- Step 3: Conduct an inventory of all nonqualified deferred compensation plans and arrangements, including arrangements that may be included in employment agreements, severance arrangements, bonus and incentive plans, and stock-based compensation programs. *Importantly, in some cases, as with hedge funds and other investment managers, this may include arrangements where an organization is a payee as well as plans and arrangements in which it is a payor.*
- Step 4: Determine how the requirements of the IRC § 409A final regulations will apply beginning January 1, 2009 to the nonqualified deferred compensation plans and arrangements identified in Step 3.
- Step 5: To the extent applicable, determine the strategy for preserving the “grandfathering” of pre-2005 deferrals against application of IRC § 409A.
- Step 6: Prepare new, or amend existing, plan documents and contracts by December 31, 2008 to make them fully consistent with the IRC § 409A requirements identified in Step 4 and the application of any grandfathering identified in Step 5.
- Step 7: Conduct sufficient in-house training of human resources and tax compliance staff to ensure that all nonqualified deferred compensation plans and arrangements are administered in accordance with the applicable requirements of IRC § 409A.
- Step 8: To the extent this has not already been done, determine the requirements of “good faith” compliance applicable to the plans and arrangements identified in Step 3 for the period from January 1, 2005 through December 31, 2008.

The IRC § 409A final regulations are exceedingly long and detailed and we have only been able to provide, here, an overview of IRC § 409A's requirements. If you would like to have a Strasburger & Price lawyer discuss an IRC § 409A compliance strategy with you, please contact Luke Bailey (214.651.4572; [luke.bailey@strasburger.com](mailto:luke.bailey@strasburger.com)).

Note: The Strasburger Tax Strategies Newsletter was originally published on August 1, 2007. It was updated on October 29, 2007 to reflect the extension to January 1, 2009 by Notices 2007-78 and 2007-86 of the requirements for full documentary and operational compliance with the requirements of the Treasury's final regulations under IRC § 409A.

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