CLIENT ALERT

Contacts

L. Scott Austin*
1445 Ross Avenue
Dallas, TX 75202-2799
(214) 979-3002

Bank of America Plaza
600 Peachtree Street, NE
Atlanta,GA 30308-2216
(404) 888-4088
saustin@hunton.com

Mark S. Dray
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074
(804) 788-8408
mdray@hunton.com

Jack T. Konther
200 Park Avenue
New York, NY 10166-0091
(212) 309-1270
jkonther@hunton.com

David A. Mustone
1751 Pinnacle Drive
McLean, VA 22102
(703) 714-7509
dmustone@hunton.com

Leslie A. Okinaka
200 Park Avenue
New York, NY 10166-0091
(212) 309-1276
lokinaka@hunton.com

Baker R. Rector
1445 Ross Avenue
Dallas, TX 75202-2799
(214) 979-3045
brector@hunton.com

J.G. Ritter, II
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219-4074
(804) 788-8402
jritter@hunton.com

Henry Talavera
1445 Ross Avenue
Dallas, TX 75202-2799
(214) 468-3386
htalavera@hunton.com

*Licensed in Texas; not yet licensed in Georgia

Section 409A—What You Need to Do in 2008 to Comply

The final Internal Revenue Service regulations governing the tax treatment of deferred compensation arrangements under section 409A of the Internal Revenue Code will go into effect **on January 1, 2009**. These rules, which generally apply to all employers *and* their employees and service providers,

→ place substantial limits on the timing of deferral elections and the form/time of "deferred" compensation payments, and

→ require all covered arrangements to comply in writing.

Because of significant tax penalties, compliance **by December 31, 2008** is a must. Set out below is (i) a brief overview of Section 409A and the impact of noncompliance, (ii) a list of arrangements that may be covered and (iii) a suggested action plan.

Overview

In general, Section 409A applies to —

→ **all employers**, either a public, private, non-profit or governmental entity, and

→ **all persons working for such entities**, either as an employee or independent contractor (*including* Board members).

In addition, Section 409A covers a wide variety of compensation and benefit arrangements (described below), including *foreign programs* for U.S. taxpayers (both U.S. citizens and resident aliens), as well as foreign nationals performing services in the United States.

Among other things, the final Section 409A regulations require that *all covered* arrangements be documented *in writing* **by the end of 2008**. The documentation must address certain Section 409A rules and requirements, such as the deferral election and distribution timing requirements and the rules for post-termination expense reimbursements. Note also that all covered arrangements must operate in compliance with the final regulations (which includes a requirement that the arrangement be operated in accordance with its written terms).

Impact of Noncompliance

The failure to comply with the final Section 409A regulations in either form or operation could result in the following adverse tax consequences for affected employees and service providers:

→ Immediate income taxation of all vested compensation/benefits under the arrangement (*and* any similar arrangements in which the affected person participates), and

- → A penalty equal to twenty percent (20%) of the total amount includable in income (e.g., if the taxable amount is $1 million, the penalty would be $200,000), *plus* a separate interest charge.

Covered Arrangements

In general, Section 409A applies to any arrangement under which the payment of compensation is deferred to a later year or to termination of employment or beyond (be it elective or non-elective). The array of arrangements to which Section 409A potentially applies includes the following:

- → *Supplemental retirement arrangements (SERPs)*
- → *Excess/restoration plans*
- → *Elective deferred compensation plans*
- → *Change in control/severance agreements*
- → *Post-termination payments, benefits and other perks*
- → *Gross-ups*
- → *Indemnifications*
- → *Cash incentive and bonus programs*

- → *Reimbursements/payments for taxable items (e.g. country club dues)*
- → *Severance pay programs*
- → *Phantom stock and restricted stock units (deferred stock)*
- → *Options & stock appreciation rights*
- → *Dividend equivalents*
- → *Employee stock purchase programs*
- → *Split-dollar arrangements*
- → *Commissions*
- → *Any other arrangements under which payment could be made more than 2-1/2 months after the year in which the payment right is earned*

Note, though, that Section 409A generally does *not* apply to any deferred compensation/benefits that were earned *and* became nonforfeitable (*i.e.*, fully vested) *before* 2005 (unless they have been materially changed).

Action Plan

Because the compliance process could be time-consuming (depending on the number and variety of covered arrange-ments involved), employers should (if they have not already done so) begin this process as soon as possible. The following should be done **by the end of 2008**:

1. Identify all compensation/benefit programs, agreements or other arrangements potentially subject to Section 409A.

2. Review each arrangement for documentary compliance and prepare needed amendments.

3. Obtain necessary Board or other internal approvals and, where individual agreements are involved, negotiate any needed changes.

4. Implement changes and review internal HR/payroll processes to ensure all covered arrangements are being operated in accordance with the operational rules and requirements under the final regulations (which include following an arrangement's written terms).

We welcome the opportunity to assist you in meeting these year-end requirements and in complying with Section 409A.