DechertOnPoint

June 2008 / Issue 57

A legal update from Dechert's Employee Benefits and Executive Compensation Group

Code Section 409A Remedial Amendment Period Scheduled to End December 31, 2008

The final regulations under §409A relating to the deferral of compensation of employees (other than through tax-qualified plans), consultants, directors, and other service providers will be effective January 1, 2009.

Although transitional rules have been available since 2004, it is believed that there will be no further extension of the transitional relief after December 31, 2008. Thus, nonqualified deferred compensation plans must be amended or documented (if not already in writing) by January 1, 2009, in compliance with the final regulations, and such plans must have been operated in a manner consistent with the final regulations.

Accordingly, every employer should compile a list of all company equity, incentive, and nonqualified retirement plans, employment agreements, severance arrangements, and other deferral arrangements potentially subject to §409A. These plans should be reviewed immediately to determine if they comply with §409A. If not in compliance, amendments must be drafted and adopted this year.

Typical problem areas include:

- Noncompliant elections to defer, accelerate, or otherwise change the manner of payment.
- Noncompliant, or failure to adopt, definitions of "Good Reason," "Change of Control," "Separation from Service," and/or "Disability."
- Failure to include a six-month delay in respect of severance payments to "specified employees" of publicly traded corporations.
- Provisions providing for payout of the same benefit in different time or manner, depending upon the reason for employment termination.
- No timing requirements regarding payment of annual bonuses, expense reimbursements, and in-kind benefits.

For example, specific §409A issues may arise with respect to deferral arrangements maintained by and/or for the benefit of investment managers and their employees or partners, where the investment manager defers its fee income from the fund(s) it is managing and individual employees or partners of the investment manager similarly defer all or a portion of their respective compensation related to such fees (so-called "back-to-back deferrals"). Under these back-to-back deferrals, distribution events that are permissible under §409A for the investment manager may not be permissible distribution events for the individual partners and employees of the investment manager and, more importantly, special attention must be paid to the investment manager's operating or partnership agreement to make certain that deferred amounts are properly accounted for and distributed in a way that reflects the member's or the partner's economic expectation.

Additionally, investment managers deferring management fees related to so-called "side-pocket" illiquid investments (typically after a

non-side pocket investment is completely liquidated) until such time as the illiquid investments are disposed of have a §409A issue because the liquidation of the side-pocket investment is not a permissible §409A payment event. The issue may be avoided by regularly invoicing investors for the "side-pocket" management fee or creating a reserve or hold-back from the proceeds otherwise payable to the investor in respect of the earlier liquidation of the non-side pocket investment.

Transitional Relief Available Until December 31, 2008

Until December 31, 2008, a plan will be deemed compliant with §409A if operated in good faith compliance with §409A. For example, existence of a haircut provision may not constitute a violation of §409A under the transitional rules so long as the discretion to allow such an early distribution (i.e., an impermissible acceleration) is not exercised. However, after December 31, 2008, all such noncompliant provisions must be deleted from the plan documentation.

In addition, prior to January 1, 2009, plan terms may be amended to adopt new payment elections, or for a different (but non-elective) time and form of payment. The election or amendment may apply only to amounts that would not otherwise be payable in 2008 and may not result in an amount being paid in 2008 that would not otherwise be payable in that year. Accordingly, this transitional provision may be used, for example, to terminate a noncompliant plan and pay plan balances to the plan's participants; however, as such distribution would have to occur no earlier than January 2009, such a plan would still need to be modified to comply with §409A.

What To Do Now

Nonqualified deferred compensation plan documentation issues not already addressed and corrected must be addressed right now. This is necessary to allow sufficient time for the drafting, approval, and adoption of remedial amendments in advance of the December 31, 2008, deadline. Failure to bring all non-qualified deferred compensation plans and arrangements, including employment, consulting, and separation agreements, into compliance by year-end may subject your valued executives and other employees to a confiscatory 20% additional tax (in addition to regular income taxation). Employers also need to focus on employment and severance agreement negotiations. These arrangements must be reviewed for §409A compliance prior to execution.

Finally, compliance with income and payroll tax withholding requirements and tax reporting requirements (i.e., Form W-2 and other information returns) must be reviewed by an employer's internal staff and/or outside accountants or other third-party service provider.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

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