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2901 Telestar Court, Falls Church, Virginia 22042
Toll Free: 1-888-275-0092 Fax: 703-641-8119
www.aalu.org

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Subject: **Full Compliance with the Final 409A Regulations Required by the End of 2008**

Major References: ***Article by Marla Aspinwall and Michael Goldstein entitled "Section 409A - What Your Clients Need to Know Before 2009"; which appears in the Summer 2008 issue of "The AALU Quarterly" (pages 8 - 12)***

Prior AALU Washington Reports: *08-34; 07-106; 07-94; 07-66; 07-50; 07-48; 07-44; 07-41; 07-38*

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All nonqualified deferred compensation arrangements that are subject to Internal Revenue Code section 409A must be in full compliance by the end of 2008 with the final regulations under that section. With less than four months remaining in 2008, plan sponsors that are not in full compliance should take action now to ensure that they can be fully compliant by the end of the year. This Washington Report will summarize the new rules and that required action. It also alerts Members to two additional AALU resources to assist with the 409A compliance requirements - (1) a Nonqualified Plan Webinar on Wednesday, September 17, 2008 at 2 PM ET presented by top practitioners Michael Goldstein, Marla Aspinwall and Stuart Lewis entitled "Section 409A: What Your Clients May Be Missing;" and (2) an article by Marla Aspinwall and Michael Goldstein entitled "Section 409A - What Your Clients Need to Know Before 2009," which appears in the Summer 2008 issue of The AALU Quarterly. (See also Washington Reports Nos. 08-34, 07-106, 07-94, 07-66, 07-50, 07-48, 07-44, 07-41 and 07-38.)

The new deferred compensation rules imposed by Code section 409A potentially apply to any arrangement that provides for the deferral of compensation (including those covering only one person). For this purpose, the term "deferral of compensation" is defined broadly to include any arrangement that provides a service provider with a legally binding right to compensation in one taxable year that may be includible in the service provider's taxable income in a later taxable year. However, the statute and the final regulations except a significant number of arrangements from the new rules. For a more detailed discussion of Code section 409A and the final regulations, including the arrangements that may be excepted, please see Washington Report No. 07-44.

409A generally imposes three new key requirements, which must be satisfied both in form and operation: (1) distribution restrictions, (2) acceleration restrictions, and (3) election restrictions. The new requirements are in addition to the existing rules, and do not replace them. As a result, a deferred compensation plan must satisfy both the new rules and the existing rules (e.g., constructive receipt, economic benefit and Code section 83 rules, to the extent applicable).

The distribution restrictions provide that deferred compensation cannot be distributed any earlier than one of six specified events - (1) separation from service (for specified employees of publicly-traded companies, the deferred compensation must not be distributed for at least six months after separation from service); (2) disability (as narrowly defined in the statute); (3) death; (4) a specified time (or fixed schedule specified under the arrangement as of the date of deferral), but not an event; (5) a change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation (to the extent provided by the Treasury); or (6) the occurrence of an unforeseeable emergency (as narrowly defined in the statute).

The acceleration restrictions provide that the deferred compensation cannot be accelerated except as otherwise provided in regulations. For example, so-called "haircut" provisions, which allow for the accelerated distribution of deferred compensation if there is a reduction in the amount payable (e.g., a 10% reduction), are no longer permissible.

The election restrictions impose requirements with respect to both the timing of a participant's initial deferral election as well as the designation of the time and form of distributions. With respect to a participant's initial deferral election, the initial election to defer compensation for services performed during a taxable year generally must be made no later than the close of the preceding taxable year. There are two statutory exceptions. First, in the case of a new plan or a participant first becoming eligible under a plan, the initial deferral election generally must be made within 30 days of initial eligibility. Second, the deferral election with respect to "performance-based compensation" can be made at least 6 months before the end of the performance period, provided such performance period is at least 12 months.

Under the new rules, the time and form of distributions must be designated at the time of the initial deferral election. However, the new rules allow for changes that further delay or change the form of payment if certain requirements are met (e.g., the change is made at least one year in advance of the originally scheduled payment date and the change delays the originally scheduled payment date at least five years).

There are significant adverse tax consequences if the new requirements are not satisfied: (1) all deferred compensation must be included in income in the current taxable year to the extent not subject to a substantial risk of forfeiture (including deferrals in prior years); (2) an additional tax is imposed equal to the interest, using the IRS' underpayment rate plus 1%, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or not subject to a

substantial risk of forfeiture, if later); and (3) an additional tax is imposed equal to 20% of the deferred compensation.

The new rules statutorily apply to amounts deferred on or after January 1, 2005. Amounts deferred (earned and vested) before January 1, 2005 are not subject to the new rules unless there is a material modification of the arrangement on or after October 3, 2004. The final regulations are generally applicable for taxable years beginning after December 31, 2008.

Written Plan Requirements

Under the final regulations, all plans subject to 409A must be in writing. The final regulations provide that a plan must specify the following items in order to satisfy the written plan requirement:

(i) the amount which the service provider has a right to be paid (or, in the case of an amount determinable under an objective, nondiscretionary formula, the terms of such formula);

(ii) the schedule or triggering events that will result in a payment of the amount;

(iii) the six-month delay requirement for payments to specified employees of publicly-traded companies upon separation from service (no later than the time such provision may be applicable); and

(iv) the conditions under which a deferral election may be made.

These items represent the minimum provisions that must be in the plan document in order to satisfy the written plan requirement. Other optional provisions permitted under the final regulations may need to be in the plan document if a plan elects to include such provisions.

The documentation requirements must be satisfied no later than December 31, 2008. However, the preamble to the final regulations states that any amendments are required only to bring the document into compliance effective January 1, 2009, and are not required to reflect any amendments made or actions taken under the transition rules to the extent such amendments or actions do not affect the plan's compliance with 409A for periods on or after January 1, 2009. Plan sponsors must also be able to demonstrate that the plan was operated in compliance with the transition guidance, including that amounts were deferred or paid in compliance with the transition rules.

Action Steps to Ensure Compliance by the End of 2008

Plan sponsors should consider the following action steps to fully comply with the final regulations by the end of 2008:

(1) Identify All Arrangements Potentially Subject to §409A

Plan sponsors should first identify all arrangements that may potentially result in a deferral of compensation. Such arrangements may include, but are certainly not limited to, traditional deferred compensation plans, supplemental executive retirement plans, excess benefit plans, employment agreements, equity compensation programs (e.g., stock options, restricted stock, stock appreciation rights, phantom stock), bonus arrangements, long-term incentive plans, change in control agreements, severance arrangements, split-dollar life insurance arrangements (see *Washington Report Nos. 07-50; 07-48; 07-41*), health and welfare benefits, and settlement agreements.

(2) Determine Which Arrangements Are Subject to §409A

Although 409A potentially applies to a broad range of plans, the statute and the final regulations except a significant number of arrangements from the new rules. Thus, the second step should be to determine which arrangements are ultimately subject to 409A.

Each arrangement identified in step 1 should be reviewed to determine whether it actually provides for a deferral of compensation, and if so, whether it may fall within one or more of the numerous exceptions that are available. The exceptions are discussed in detail in *Washington Report No. 07-44* and the article by Marla Aspinwall and Michael Goldstein entitled "Section 409A - What Your Clients Need to Know Before 2009."

(3) Determine the Changes Needed to Comply or Fall Within an Exception

To the extent an arrangement is subject to 409A and currently does not fall within an exception, plan sponsors should identify the changes that need to be made to comply with the final regulations or to fall within an exception. In certain cases, an arrangement may be modified by the end of this year to fall within an exception.

(4) Identify the Actions Needed to Make Any Changes

To the extent an arrangement must be modified to comply with 409A or to fall within an exception, the arrangement should be reviewed to determine what actions are needed to make such changes. For example, some arrangements require the consent of the participants before any changes can be made. Similarly, some arrangements require board of director approval and/or shareholder approval before changes can be made. Plan sponsors should identify the actions that must be taken to make any changes and begin to initiate the steps necessary to complete all such actions by the end of this year.

(5) Determine Compliance During Transition Period

All arrangements subject to 409A were subject to the new rules with respect to amounts deferred on and after January 1, 2005. Plan sponsors are required to comply with the new rules during the transition period under a reasonable, good faith compliance standard. Plan sponsors should review the plan operations during the transition period to confirm that the arrangements have complied under a reasonable, good faith compliance standard and document such compliance. In addition, there are a number of special transition rules that have applied during the transition period. A number of the transition rules will continue through the end of 2008 (see *Washington Report No. 07-106*). Plan sponsors should determine the extent to which transition rules will be used by the end of this year and take whatever actions may be necessary to comply with such transition rules.

(6) Prepare Written Plan Documents

All plans that are subject to 409A must be in writing and in full compliance with the final regulations by the end of 2008. Thus, to the extent an arrangement is currently in writing, it may have to be amended to comply by the end of this year. If an arrangement that is subject to 409A is not currently in writing, a written document will have to be prepared by the end of this year.

(7) Obtain Approvals and Finalize Plan Documents

Plan sponsors should complete all of the actions required to comply and obtain all of the necessary approvals and authorizations by the end of this year. In addition, all of the written plan documents should be finalized and executed, as necessary, by the end of this year.

(8) Ensure Continuing Compliance Both in Form and Operation

Although plan sponsors will be focusing on full compliance by the end of this year, plan sponsors should also begin to identify and adopt policies and procedures to ensure continuing compliance in the future both in form and operation. For example, any new arrangements that may potentially be subject to 409A should be identified and reviewed before they are put in place. In addition, any proposed changes to existing arrangements that may potentially be subject to 409A should be similarly identified and reviewed for compliance. Polices and procedures should also be implemented to ensure operational compliance.

409A Compliance Webinar - September 17, 2008

AALU is sponsoring a Nonqualified Plan Webinar on Wednesday, September 17, 2008 at 2:00 PM ET entitled "Section 409A: What Your Clients May Be Missing." The Webinar will be presented by industry leaders Michael Goldstein, Marla Aspinwall, and Stuart Lewis. Members can register for this Webinar at the AALU website at www.aalu.org.

Any AALU member who wishes to obtain a copy of *The AALU Quarterly* article entitled "Section 409A - What Your Clients Need to Know Before 2009" may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at ruselowski@aalu.org and include a reference to this *Washington Report*.

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