

July 2008

IMPORTANT DEADLINE UNDER SECTION 409A APPROACHING FOR NONQUALIFIED DEFERRED COMPENSATION PLANS AND FACULTY MEMBERS OF ACADEMIC INSTITUTIONS

This is a reminder that the deadline for compliance with the Internal Revenue Code Section 409A rules is approaching quickly. In addition, this is an alert to all academic institutions to a potential Section 409A issue affecting their faculty members that must be addressed prior to the beginning of the next academic year. It is very unlikely that either of these deadlines will be extended further. Therefore, it is important that any necessary action be taken promptly.

The December 31, 2008, compliance deadline for plan documents

As discussed in previous Client Alerts, Section 409A imposes restrictions on the design, operation and administration of nonqualified deferred compensation arrangements. Last year, the Treasury Department and the Internal Revenue Service issued Notice 2007-86, which extended until December 31, 2008, the deadline for nonqualified deferred compensation plans to comply with the written plan requirements under the final regulations. This deadline is fast approaching. Any deferred compensation that is included in an employee's income as a result of a failure to comply with Section 409A is subject to an additional 20% penalty tax, payable by the employee, as well as potential interest charges.

Any employer who has not already done so should:

- Assemble a list of all plans, agreements, and contracts that could potentially be subject to Section 409A. Any arrangement that gives an employee the right to compensation that will or may be paid in a later year could be subject to Section 409A, including, but not limited to, certain stock options, stock appreciation rights, supplemental executive retirement plans ("SERPs"), cash bonus plans, employment agreements, severance agreements, and change in control agreements. Keep in mind that unwritten plans or arrangements may also be subject to 409A.
- Review and amend affected plans. All affected plans must be reviewed and amended to comply with the requirements of Section 409A by December 31, 2008. Unwritten plans that are subject to Section 409A must be reduced to writing by December 31, 2008.
- Review plans and procedures for operational compliance. Plans should be reviewed to ensure that they operate in accordance with the terms of the plan document and Section 409A. Each employer should also implement internal procedures to ensure compliance with Section 409A with respect to both the operation and maintenance of any affected plans, proper reporting and withholding of compensation, and review of any new plans or arrangements prior to execution.

Other December 31, 2008, compliance deadlines under Section 409A

- A nonqualified deferred compensation plan may provide, or be amended to provide, for a new payment election for both time and form of payment by December 31, 2008, without violating the rules against acceleration of payment or changes in time and form of payment. However, an election made in 2008 may not accelerate into 2008 an amount that would be payable in a later year, nor may the election defer until a subsequent year any amount that would otherwise be payable in 2008. A deferral from one post-2008 year to another would be permissible, as would an acceleration to one post-2008 year to another.

- Until December 31, 2008, nondiscounted stock options and stock appreciation rights may be substituted for discounted ones, and discounted stock options (other than those granted to Section 16 officers and directors) may be cancelled and reissued, subject to certain restrictions.
- The ability to link a payment election under a nonqualified deferred compensation plan to an election under a qualified plan expires December 31, 2008.

Section 409A Alert for Academic Institutions

Faculty members and other school employees that are under a 10-month contract for a school year that begins in one calendar year and ends in the following calendar year, but who choose to be paid over a 12-month period, have potential tax liability under Section 409A.

An election to receive a 10-month salary over a 12-month period is effectively a deferral of a portion of the salary earned during the fall portion of the 10-month school year, and thus is a deferral of income under Section 409A. Faculty members who either receive a 10-month salary over 10 months, who are required by their institution to spread their 10-month salary over 12 months, or who are under a 12-month contract that requires them to receive their salary over 12 months have not elected to defer their income and would not incur tax liability under Section 409A.

On July 1, 2008, the IRS announced in Notice 2008-62 that it plans to propose regulations under Section 457(f) that will exclude most compensation arrangements where faculty members have the option of being paid over a 12-month period from the definition of deferred compensation if the arrangements meet certain requirements. While the IRS also noted in Notice 2008-62 that it anticipates a change to the final regulations issued under Section 409A providing that such arrangements are not nonqualified deferred compensation plans for purposes of Section 409A, the best way at present to ensure that affected faculty members avoid tax liability under Section 409A is to amend their contracts or have them execute a written election, as discussed below.

Academic institutions have two options to ensure that their faculty members avoid tax liability under Section 409A. First, the institution could review contracts for the upcoming academic year and amend any contracts which expose faculty members to potential tax liability so that the contracts are in compliance with Section 409A. For example, the contracts could be amended to require faculty members to receive their salary over a 12-month period, instead of merely making it an option for them. Another option is to have faculty members execute written elections to defer compensation that comply with the requirements of Section 409A. Both options will require institutions to determine how they will communicate with their faculty members to make them aware of their options for avoiding tax liability.

Under Section 409A, an employee must generally make an election to defer compensation before the beginning of the year in which the services are performed. Therefore, to avoid tax liability for deferred compensation, faculty members must make an election prior to the beginning of the academic year to which it applies. To be absolutely certain that the election is timely made, institutions should not wait until the first day that faculty must report to school to have them sign an election, but should instead communicate with affected faculty prior to the beginning of the year to ensure that a written election is in place before any service is rendered by the faculty member for the academic year. Elections must meet the following requirements:

- The election must be in writing (e-mail is sufficient), and it must inform the institution that the faculty member wishes to exercise his or her option to spread the 10-month salary over a 12-month period;
- The election must be irrevocable for the academic year once school has begun;
- The election must state how the faculty member's compensation will be paid (e.g., ratably over a 12-month period);

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- The election may specify that it is to be effective for a specific period of time, or indefinitely until it is changed or superseded. However, to be effective, any new election must be made prior to the school year to which it applies.

If a faculty member fails to make a written election that meets the above requirements, any deferred compensation that is included in his or her income as a result of a failure to make an election that complies with Section 409A is subject to an additional 20% penalty tax, payable by the faculty member.

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Additional Information

If you have any questions regarding this client alert, please contact [James Daniel](#) or [Elisa Cawood](#). You may also contact the Womble Carlyle attorney with whom you usually work or one of our Employee Benefits attorneys listed on the following webpage:

[Womble Carlyle Sandridge & Rice Employee Benefits Lawyers](#)

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