

NONQUALIFIED DEFERRED COMPENSATION PLANS AND ARRANGEMENTS
SUMMARY OF THE FINAL REGULATIONS FOR SECTION 409A

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I. INTRODUCTION

In October 2004, Congress passed the American Jobs Creation Act of 2004, which added Section 409A to the Internal Revenue Code. Section 409A places significant restrictions on the form and operation of nonqualified deferred compensation plans and arrangements ("NQDC plans").

On April 10, 2007, the Treasury Department and the Internal Revenue Service issued final regulations under Section 409A. The final rules adopt a substantial portion of the proposed regulations that were issued October 4, 2005 and are also consistent with interim guidance published in late 2004 as IRS Notice 2005-1. However, the final regulations address many questions and issues raised by commentators by clarifying and adding flexibility to some of the proposed rules.

II. EFFECTIVE DATE OF THE FINAL REGULATIONS

In short, full documentary and operational compliance is required as of December 31, 2007.

The final regulations are effective January 1, 2008. Employers may rely on the final regulations immediately or they may continue to rely on the proposed regulations and other prior guidance until December 31, 2007 so long as the plans are in good faith compliance with the prior guidance. Employers must adopt any necessary amendments to their NQDC plans to comply with the final regulations by December 31, 2007. Significantly, the final regulations explicitly state that employers will not be allowed to rely on "savings clauses" in their documents if the plan provisions do not comply with the final regulations.

III. SCOPE OF SECTION 409A

A. In General

The general premise of Section 409A is that, unless certain requirements are met, amounts deferred under a NQDC plan for all taxable years are currently includible in gross income to the extent that they are not subject to a substantial risk of forfeiture and have not previously been included in income.

The Section 409A rules generally apply to amounts deferred after 2004 under a plan that provides for the "deferral of compensation." A deferral of compensation occurs if a service

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provider (i.e., an employee or independent contractor) has a legally binding right during a year to compensation that is *or may be* payable to the service provider in a later year.

The final regulations exclude or exempt from 409A coverage many types of arrangements that otherwise provide for a deferral compensation under this definition.

B. Specific Exclusions

The following types of deferral arrangements are specifically excluded from Section 409A coverage:

- Qualified plans, such as a 401(k) plan or a profit sharing plan;
- Section 457(b) plans;
- Any vacation leave, sick leave, compensatory time, disability pay or death benefit plan;
- Stock option plans with an exercise price at least equal to the fair market value of the underlying stock on the grant date and with no additional deferral features;
- Incentive stock options;
- Stock appreciation rights with an exercise price not less than the fair market value of the underlying stock on the grant date; stock that is traded on an established securities market; only the traded stock may be delivered at exercise; and no additional deferral features;
- Employee stock purchase plans; and
- Short-term deferrals not exceeding 2 ½ months after the close of the later of the participant's or employer's tax year.

C. Other Exemptions

1. Grandfathered Benefits

Section 409A does not apply to rights that accrued and vested prior to January 1, 2005 (including subsequent earnings), provided those rights are not materially modified after October 3, 2004.

The final regulations provide detailed rules for determining how much of a benefit is grandfathered, depending on whether the program is an account balance, a nonaccount balance, or an equity-based plan.

Although not required, to ensure that any changes made to non-grandfathered benefits will not inadvertently cause grandfathering to be lost for grandfathered benefits, it is strongly recommended that employers separate grandfathered benefits from non-grandfathered benefits (either through separate plans or clearly and distinctly within the same document).

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2. Short-Term Deferrals

Section 409A does not apply to a payment (that was not subject to a deferral election) that is actually or constructively made to a service provider by the 15th day of the third calendar month following the end of the later of the first taxable year of the service recipient or of the service provider in which the amounts are no longer subject to a substantial risk of forfeiture.

- a. It is not necessary that the plan document specify that the payment will be made within the 2 ½ month period as long as the payment is actually made within the 2 ½ month period.
- b. If payment is contingent on an event that may occur outside the 2 ½ month period (e.g., termination of employment), it will not qualify for the short-term deferral rule.
- c. Where payment beyond the 2 ½ month period is due to unforeseen administrative delay or payment would jeopardize the ability of the employer to continue as a “going concern,” the delayed payment will not jeopardize the short-term deferral rule.

3. Separation Pay

The final regulations will generally exempt most separation pay from Section 409A coverage.

- a. Separation pay refers only to compensation that is conditioned upon an employee’s separation from service (including separation due to death or disability), but does not include compensation that the employee could receive without separating from service (e.g., amounts also payable upon a change in control, an unforeseeable emergency or a date certain).
- b. Section 409A does not apply to separation pay paid upon an involuntary separation of employment to the extent that the payments do not exceed two times the lesser of the employee’s annual compensation or two times the Code Section 401(a)(17) compensation limit (a maximum of \$450,000 in 2007).
- c. If certain requirements are met, a voluntary separation from service for “good reason” will be treated as involuntary. There is a facts and circumstances test and a safe harbor method for treating a good reason termination as involuntary:
 - i. Facts and circumstances – The good reason condition involves a material adverse change in the employment relationship.
 - ii. Safe harbor – The safe harbor requirements include:

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1. The separation from service must occur within two years following the occurrence of the adverse condition.
 2. The adverse conditions include material diminution in the employee's base compensation, authority or duties (or the duties of the employee's supervisor), the budget over which the employee has authority, a material change in the employee's job location or a material breach of the terms of the employee's employment contract.
 3. The amount, time and form of payment must be substantially identical to the amounts paid upon an actual involuntary separation; and
 4. The employee must provide notice to the employer during a period not to exceed 90 days of the initial existence of the adverse condition and the employer has at least 30 days to cure.
- d. The final regulations provide that if the aggregate amount of other payments does not exceed the annual limit under Code Section 402(g) (\$15,500 for 2007) for the year of separation, the amount is not subject to Section 409A.
- e. The final regulations provide guidance on when a separation from service occurs. Whether a separation from service has occurred will be determined on the facts and circumstances. However, the parties' written characterization of the separation will be rebuttably presumed to be correct. A separation from service occurs if the parties reasonably anticipate that no further services would be provided as of a certain date or that the services that would be performed by the employee after that date would be at a certain reduced level. In determining whether the employee has separated from the employer's service, the employer is determined on a controlled group basis, under which entities that are 50% or more related are treated as a single employer.
- f. Other post-employment benefits:
1. Benefits provided for a limited time after a termination such as business expense reimbursements, medical expenses, the provision of in-kind benefits (office space), moving and relocation payments, and outplacement expenses are exempt from Section 409A.
 2. Reimbursements may be made up to the end of the third year after the year of termination as long as the expense was incurred by the end of the second year.
 3. Taxable reimbursements of medical expenses will be limited to the 18-month COBRA continuation period.

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4. The final regulations describe how to structure nonexempt amounts, such as taxable reimbursements and tax gross up payments to comply with the distribution provisions of Section 409A.
4. Equity Compensation: Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock
 - a. Nonqualified stock options and stock appreciation rights are exempt from Section 409A coverage if the stock right is granted for not less than the fair market value of the underlying stock at the grant date, the stock right does not include any deferral feature, and the number of shares covered by the grant are fixed on the grant date.
 - b. The exercise period of an option or SAR may be extended up to the end of the original term of the option or SAR (up to a maximum of ten years from the date of grant) without the extension being treated as an additional deferral feature that would cause a Section 409A violation. "Underwater" options may also be extended without violating Section 409A.
 - c. The final regulations expand the types and classes of stock ("service recipient stock") that exempt stock rights can cover.
 - i. Any class of common stock qualifying under Code Section 305 may be used.
 - ii. The corporation for which an employee was providing services at the date of grant and any corporation above that corporation in a chain of organizations all of which have a controlling interest in another may issue the stock. The chain begins with the parent organization and ends with the corporation for which the employee was providing services at the date of grant. The regulations contain detailed rules on how to determine when an organization has a controlling interest in another.
 - iii. Stock rights issued before April 10, 2007 that were designated as service recipient stock under a reasonable, good faith interpretation of that term will continue to be deemed to be service recipient stock.
 - d. The term "date of grant" has the same meaning as under the incentive stock option regulations. Thus, the phrase refers to the date when the granting corporation completes the corporate action necessary to create the legally binding right constituting the option.
 - e. The valuation of stock that is not readily tradable on an established securities market may be determined based on a reasonable application of a reasonable valuation method. An independent appraisal is not required.

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- f. An employer may use one valuation method for purposes of establishing an exercise price and then switch to another method that is used to determine the fair market value of the stock at time of payment. However, once established, the exercise price cannot be changed through the retroactive use of another valuation method.
- g. Restricted stock grants are exempt from Section 409A coverage if the forfeiture condition requires continued performance of services for at least 12 months, and the election is made within 30 days after the grant date and at least 12 months in advance of the earliest possible vesting date.

5. Supplemental or "Mirror" Plans

Some employers supplement their qualified 401(k) plans with a NQDC plan that "mirrors" the 401(k) plan by allowing participants to defer compensation in excess of the amounts that can be deferred under the qualified plan limitation (e.g., \$15,500 in 2007). The final regulations require that NQDC mirror plans must provide for elections independent of the underlying qualified plan. Any supplemental or mirror plans that are currently designed to "piggyback" on the qualified plan's deferral elections will need to be redesigned and amended.

6. Section 457(f) Plans (Tax exempt and governmental employers)

Amounts deferred under Section 457(f) plans are includible in income when the amounts are no longer subject to a substantial risk of forfeiture. Section 457(f) plans may also be subject to Section 409A. The Section 409A regulations coordinate the applicability of the short-term deferral exception to a Section 457(f) plan. For purposes of the short-term deferral exception an amount is treated as paid from a Section 457(f) plan when it is included in income under Section 457(f) whether or not an actual or constructive payment is made.

7. Legal Settlements and Indemnification

The final regulations exempt from Section 409A coverage:

- a. Settlements or awards that resolve bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act or workers' compensation statutes regardless of whether such settlements or awards are treated as compensation for federal tax purposes. This exemption includes payment of or the reimbursement for attorneys' fees.
- b. Indemnification payments in connection with a claim for damages resulting from services by the employee and liability insurance coverage providing for payment in the event of a claim.

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8. Plan Aggregation

NQDC plans of a similar type are aggregated and treated as one plan for certain purposes under Section 409A. If a violation occurs due to an improper distribution to an employee under a plan, the Section 409A penalty provisions would apply to all amounts under that plan and all other plans of the same type in which the employee participated. The plan categories are:

- a. Elective account balance plans;
- b. Nonelective account balance plans (profit sharing type plans);
- c. Nonaccount balance plans (SERPS);
- d. Involuntary separation pay plans;
- e. In-kind benefits and reimbursements;
- f. Split dollar life insurance arrangements;
- g. Foreign plans;
- h. Stock rights (options and SARs); and
- i. Other plans.

IV. DEFERRAL ELECTION RULES

A. General Rule

An initial election to defer compensation must be made by the close of the year preceding the year in which compensation subject to the deferral election is earned. The election must include the time and form of payment and must be irrevocable as of the deadline for making the election. Nonelective deferrals must satisfy the time and form of payment rules and be irrevocable.

B. New Participants

Generally, an election to defer compensation may be made within 30 days after the date an employee first becomes eligible to participate in a plan. An employee will only be treated as a new participant in a plan if he has not previously participated in any plan of a similar type maintained by the employer. In the case of re-hire, the 30-day rule will apply if the employee has not been an active participant in such a plan for at least 24 months. As to a nonelective excess benefit plan, an employee may be treated as newly eligible to participate as of the first day of the year after the first year the employee accrues a benefit under the plan.

C. Performance-Based Compensation

An election to defer "performance-based compensation" that has a performance period of at least 12 months may be made as late as six months before the end of the period as long as the election is made before compensation is readily ascertainable. "Performance-based compensation" means compensation that is contingent upon the satisfaction of pre-established organizational or individual performance criteria relating to a performance period of at least 12 consecutive

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months. The final regulations clarify that provisions that permit distribution of compensation upon death, disability or change in control without regard to whether the performance criteria are satisfied will not cause the compensation to fail to qualify as performance-based.

V. PAYMENTS AND DISTRIBUTIONS

A. General

Per Section 409A and the final regulations, payments may be made no earlier than:

1. A fixed date or under a fixed schedule;
2. Separation from service;
3. Death;
4. Disability;
5. Change in control; or
6. Unforeseeable emergency.

A plan may provide for payments upon the earlier of, or later of, two or more specified permissible events. Distributions to "specified employees" as a result of a separation from service may not be made for at least six months after the separation. Any "subsequent election" to change the time or form of a distribution generally may not take effect for 12 months and must provide for a new distribution date that is at least five years after the date the distribution would have otherwise been made. Generally, acceleration of payment under a NQDC plan is prohibited, but is subject to certain exceptions.

B. Objective Payment Date Required

For payment as a result of an event (i.e., separation from service, death, disability, change in control, or unforeseeable emergency), the plan must state the date of the event as the payment date or designate an objectively determinable date following the event upon which the distribution is to be made or commence. Significantly, a payment will be treated as made on the designated distribution date if made by the later of (i) the end of the year containing the designated date or (ii) the 15th day of the third month following the designated date. The final regulations do not allow the same flexibility as to payments that precede the designated date within the same calendar year. Instead, the final regulations provide relief for an early payment if it is made within the 30-day period before the designated date and the employee is not permitted to elect the taxable year of payment.

The final regulations permit payment "as soon as administratively feasible" after a payment event as long as certain conditions are met. The potential payment period must be expressly restricted to one taxable year or must be no longer than 90 days and the employee must not be permitted to elect the taxable year of payment. For example, it is permissible for a NQDC plan to provide for payment as soon as administratively feasible within 90 days of a separation from service. For

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purposes of the subsequent deferral election rules, the date of the separation from service will be used.

C. Multiple Payment Events Permitted

A NQDC plan may provide for different forms of distribution depending on the actual triggering event. A plan may also allow for an alternate distribution schedule if a specific triggering event occurs before or after a specified date. Alternate distribution schedules are also permissible for different types of separation from service. Additions or deletions to a different distribution schedule applicable to an existing deferral is subject to the subsequent deferral election rules and the rules that prevent acceleration of payments.

D. Certain Delayed Distributions Allowed

Distributions may be delayed under certain circumstances:

1. If a scheduled payment would jeopardize the employer's ability to continue as a going concern, payment may be delayed until the first taxable year in which the payment would not have that effect.
2. A scheduled payment may be delayed if payment is subject to the operation of a fixed or objective formula limitation. For example, payments during any given year may be limited to a certain percentage of cash flow.
3. Delay is permissible if the employer's deduction under Code Section 162(m) would be limited or distribution would violate securities laws.
4. If the employer refuses to pay benefits, payment may be delayed provided the employee makes a prompt, reasonable, good faith effort to collect the payment.

E. Distributions on "Separation from Service"

The final regulations set forth guidelines for determining whether an employee "separates from service" for Section 409A purposes. There is a rebuttable presumption that an employee is presumed to separate from service if the level of services performed actually decreases to 20% or less of the employee's average service level measured over the preceding three-year period. If an employee's level of services actually continues at a rate that is 50% or more of his average service level, there is a presumption that the employee has not separated from service. The key is determining what the parties' reasonably anticipated at the time of separation.

The definition of "employer" for purposes of separation from service is determined on a controlled group basis using the rules in Code Sections 414(b) and (c), but with a 50% ownership level rather than 80%.

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In corporate transaction situations, the seller and buyer are permitted to specify whether employees who go to work for the buyer after the sale have experienced a separation from service for purposes of Section 409A.

F. Distributions on "Disability"

1. For purposes of Section 409A, a plan participant is considered disabled if he or she meets one of the following requirements:
 - a. The participant is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or
 - b. The participant is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.
2. The NQDC plan may specify that a participant will be deemed disabled if determined to be totally disabled by the Social Security Administration or Railroad Retirement Board. The plan may also specify that a participant will be deemed disabled if determined to be disabled in accordance with a disability insurance program provided that the insurance program's definition of disability complies with the definition in the 409A regulations.
3. The NQDC plan is not required to specify who will make the disability determination.

G. Distributions on "Change in Control"

1. For purposes of Section 409A, a NQDC plan may permit payments upon the "change in control" of the corporation. Under the regulations, "change in control" means:
 - a. A change in the ownership of a corporation, which occurs when one or more persons acquires more than 50% of the total fair market value or total voting power of the stock of the corporation;
 - b. A change in effective control of a corporation, which occurs either when one or more persons acquires in a 12-month period 30% of the total voting power of the stock of the corporation, or when the majority of members of the corporation's board of directors is replaced during any 12-month period whose appointment or election is not endorsed by a majority of the directors in office before the appointment or election;
 - c. A change in the ownership of a substantial portion of a corporation's assets, which occurs when one or more persons acquires in a 12-month period assets from the

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corporation that have a total gross fair market value equal to or more than 40% of the total gross fair market value of the corporation's assets.

- d. For purposes of the "change in control" definitions under Section 409A, an employer may substitute into a NQDC plan a higher percentage of ownership or a number greater than a majority of directors as the condition that would require payments of amounts subject to the NQDC plan.
2. The final regulations do not address change in control provisions regarding non-stock, non-profit corporations. The IRS is considering future guidance on this issue. Meanwhile, the preamble states that until further guidance is issued, a non-stock, non-profit corporation may apply the change in effective control provisions relating to a change in the composition of the board of directors as an analogy to changes in the composition of its board of directors, trustees or other governing body.

H. Distributions on "Unforeseeable Emergency"

1. An "unforeseeable emergency" is a severe financial hardship that results from:
 - a. An illness or accident of the service provider, his or her spouse, beneficiary or dependents;
 - b. Loss of the service provider's property due to casualty;
 - c. Other similar extraordinary and unforeseeable circumstances that arise as a result of events outside the control of the service provider, such as imminent foreclosure or eviction, the need to pay for medical expenses, or the need to pay for funeral expenses of a spouse, beneficiary or a dependent.

The purchase of a home or payment of college tuition is not an unforeseeable emergency.

2. The following financial sources need not be considered in determining whether an unforeseeable emergency may be relieved through other means:
 - a. Other NQDC plans including grandfathered deferred compensation; and
 - b. Amounts available under qualified plans.
3. Amount that can be distributed is limited to the amount needed to satisfy the emergency needs plus taxes.

I. "Specified Employee" Rules

Section 409A provides that distributions to "specified employees" of publicly traded companies may not be made for at least six months after the separation. "Specified employee" generally means a "key employee" as defined in Code Section 416(i) of a publicly traded company on any United States or foreign exchange. "Key employee" means an officer with annual compensation

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of more than \$145,000 (in 2007), a 5% owner, or a 1% owner with an annual compensation of more than \$150,000.

J. Subsequent Deferral Election Rules

The rules that apply to changes in time and form of payment apply to changes made by both employers and employees. "Subsequent elections" may not take effect for 12 months and must provide for a new distribution date that is at least five years after the date the distribution would have otherwise been made. The subsequent election rules are complex

K. Prohibition on Accelerated Distributions

There are several exceptions and clarifications to the general rule that prohibits the acceleration of a scheduled payment:

- a. The payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation.
- b. An employee may not have discretion to determine whether a payment will be accelerated under an exception permitting the acceleration of payments. However, a plan may allow the employer to have discretion to accelerate payment under an exception and the failure to accelerate will not constitute a subsequent deferral election.
- c. Payments may be accelerated where the right to payment arises pursuant to the settlement of a bona fide dispute over an employee's right to deferred compensation.
- d. Generally, a deferral election can be cancelled due to the employee's disability.
- e. Death, disability or unforeseeable emergency can be added as a potentially earlier alternative payment event to an amount previously deferred.
- f. Payments may be accelerated when necessary to avoid the violation of a federal, state, local or foreign conflict of interest or ethics law, or where necessary for an employee in the executive branch to comply with an ethics agreement with the federal government.
- g. The final regulations do not permit accelerated payments to employees who do not satisfy the "select group" requirements under the ERISA "top hat" plan exception.

L. Distributions on Plan Termination

The employer is allowed to terminate a plan and distribute benefits without violating the prohibition on acceleration of payments in certain circumstances. An employer may terminate a plan and distribute benefits if:

- a. The termination does not occur proximate to a downturn in the employer's financial health;

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- b. All plans of the same type maintained by the employer are terminated with respect to all participants;
- c. No payments are made within 12 months of the plan termination other than payments that would have been paid absent the termination;
- d. All payments are made within 24 months of the plan termination; and
- e. The employer does not adopt a plan of the same type for a period of three years following the date of plan termination.

Also, a plan may be terminated in connection with a change in control, corporate liquidation or with the approval of the bankruptcy court.

M. Other Distribution Rules

- a. Suspension of the payments of deferred compensation following the rehire of an employee will violate the rules governing time and form of payment because payments would be delayed other than as permitted under the subsequent deferral election rules.
- b. Beneficiaries are subject to the same time and form of payment rules regarding subsequent deferrals and accelerated payments.
- c. Amounts subject to domestic relations orders are not subject to the rules governing subsequent deferrals, accelerated payments or the six-month delay for specified employees.

VI. DOCUMENT COMPLIANCE REQUIREMENTS

- A. The written terms of a NQDC plan may be in one or more documents.
- B. At the time an amount is deferred, the plan documents must specify the amount ultimately to be paid (or a formula to calculate it) and the time and the form of payment.
- C. The plan documents must set forth the conditions under which deferral elections (and subsequent deferral elections) may be made.
- D. Plan documents must contain the six-month delay rule on payment to key employees of public companies by the time an employee becomes subject to the rule.
- E. Plan documents need not set forth conditions under which accelerated payments permitted under Section 409A will be made.
- F. Plan documents must be brought into compliance by December 31, 2007.
- G. Actions taken during the good faith compliance period need not be contained in the documents that effective January 1, 2008.
- H. A "Section 409A savings clause" will not cure noncompliant plan documents.

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VII. REPORTING REQUIREMENTS

A. Reporting Guidance

1. Report annual deferrals on a Form W-2 or Form 1099
2. Code Y, Box 12 – Annual Deferrals
3. Code Z, Box 12 – Income due to failure to comply with section 409A

B. More Guidance to Come

VIII. ACTION STEPS FOR EMPLOYERS

- A. Identify all deferred compensation plans
- B. Review plans for Section 409A compliance
- C. Identify needed changes
- D. Decide whether to amend, freeze or terminate plans
- E. Amend NQDC plans by December 31, 2007
- F. Preserve grandfathered plans and amounts
- G. Establish relationships with knowledgeable third party administrators
- H. Inform participants of changes made to the plans

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