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Benefits Alert

for Colleges and Universities

At Last! Final Regulations for Nonqualified Deferred Compensation Plans

After much anticipation, the Internal Revenue Service issued final regulations under Section 409A of the Internal Revenue Code providing guidance for nonqualified deferred compensation arrangements and clarifying the treatment of ineligible deferred compensation arrangements under Section 457(f) (“ineligible plans”). The requirements of Section 409A apply separately and in addition to the rules applicable to ineligible plans under Section 457(f).

In general, Section 409A imposes requirements on nonqualified deferred compensation arrangements to specify the timing of distributions, prohibit the acceleration of benefits, and require that deferral elections be made within certain time frames. Failure to satisfy these requirements will result in immediate income taxation to the employee of all amounts deferred under the arrangement, plus a 20% additional tax and interest, even if amounts are not currently payable under the plan.

Section 409A does not apply to “short-term deferrals.” The short-term deferral rule provides that a deferral of compensation does not occur if an amount of compensation is actually or constructively received by the employee within 2½ months following the later of the end of the employee’s taxable year or the end of the employer’s taxable year in which the amounts deferred are no longer subject to a substantial risk of forfeiture.

For example, assume that both the employee and employer are calendar year taxpayers. If the employee’s deferred compensation is no longer subject to a risk of forfeiture (i.e., vests) in Year 1 and the plan provides for distribution of such compensation no later than March 15 of Year 2, such compensation will be treated as a short-term deferral which is not subject to Section 409A.

Under Section 457(f), employees participating in an ineligible plan are subject to income tax in the taxable year in which the compensation vests.

Under the final regulations, most ineligible plans will avoid application of Section 409A using the short-term deferral rule. Only ineligible plans that do not fully distribute vested amounts within the short-term deferral period will be required to satisfy the requirements of Section 409A.

If payments under an ineligible plan do not satisfy the short-term deferral rule, the plan must be amended in written form to conform to the requirements of Section 409A and the final regulations no later than **December 31, 2007**.

In addition, the final regulations provide that taxpayers may continue to rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan applicable for purposes of section 457(f) as also being applicable for purposes of Section 409A. This welfare benefit plan exception does not apply to severance arrangements, which may be subject to Section 409A.

If your organization sponsors any ineligible plans or severance arrangements providing for payments over a period of time extending beyond the short-term deferral period, please contact one of the members of our Employee Benefits team listed on the reverse of this Alert to review the plan for compliance with the final regulations.

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Employee Benefits & Executive Compensation Team

James S. Kolan has an extensive background in tax planning and executive compensation plans. He is a certified public accountant and previously practiced with the firms of Ernst & Young and Deloitte & Touche. Jim is a member of the Tax Section of the American Bar Association. He received his J.D., *cum laude*, from the University of Pittsburgh School of Law and his LL.M. from New York University. Jim can be reached at 757.624.3135 or jskolan@kavfc.com.

Carol M. Williams is a paralegal assigned to the attorneys in the Employee Benefits Practice Group. She has over ten years of ERISA and Employee Benefits experience. She can be reached at 757.624.3149 or cmwilliams@kavfc.com

Richard C. Mapp, III has practiced in the area of employee benefits and executive compensation matters for over 20 years. He is the Chairman of the firm's Employee Benefits Practice Group, where his practice includes pensions, profit sharing, ESOPs, stock bonus plans, deferred compensation and other executive compensation programs and employee welfare benefit plans. His practice involves advising large and small businesses and government entities. Rick can be reached at 757.624.3285 or rcmapp@kavfc.com.

Shad C. Fagerland's broad employee benefits background includes experience in pension and welfare benefit plan design as well as fiduciary and benefits litigation. He is a member of the Taxation Section of the American Bar Association and an active member of the District of Columbia Bar. Prior to joining Kaufman & Canoles, Shad practiced in the Employee Benefits group at a Washington, DC tax boutique. Shad can be reached at 757.259.3828 or sctagerland@kavfc.com.

Priscilla Balderama is a Certified Legal Assistant assigned to the attorneys in the Employee Benefits Practice Group. She can be reached at 757.624.3316 or pbalderama@kavfc.com