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What You Need to Know About the New Deferred Compensation Rules

The U.S. Treasury Department has issued new regulations governing the tax treatment of deferred compensation arrangements under Section 409A of the Internal Revenue Code. The regulations will go into effect **on January 1, 2009**.

These rules

- place substantial limits on the timing of deferral elections and the form/time of “deferred” compensation payments, and
- require all covered arrangements to be in writing.

In order for you to avoid significant personal tax penalties, your employer must comply with the new rules **by December 31, 2008**.

Overview

In general, Section 409A applies to —

- **all employers**, either a public, private, non-profit or governmental entity, and
- **all persons working for such entities**, either as an employee or independent contractor (*including* Board members).

Section 409A covers a wide variety of compensation and benefit arrangements (described below).

Among other things, the final Section 409A regulations require that *all covered* arrangements be documented *in writing before January 1, 2009*. The documentation must address specific Section 409A rules and requirements, such as the deferral election and distribution timing requirements and the rules for post-termination expense reimbursements. Note also that your employer must operate all covered arrangements in compliance with the final regulations (for example, your employer must administer the arrangement in accordance with its written terms).

Noncompliance Can Be Costly

The failure to comply with the final Section 409A regulations in either form or operation could trigger the following adverse personal tax consequences for you:

- Immediate recognition of income equal to all vested compensation/benefits under the arrangement (*and* any other similar arrangements in which you participate), plus
- A penalty equal to twenty percent (20%) of the total amount includable in income (for example, if your vested benefits are valued at \$1,000,000, you would be subject to an additional

penalty of \$200,000), plus a separate interest charge.

Do the New Rules Apply to You?

In general, Section 409A applies to any arrangement under which the payment of compensation is deferred to a later year or to termination of employment or beyond (be it elective or non-elective). The array of arrangements to which Section 409A potentially applies includes the following:

- Supplemental retirement arrangements (SERPs)
- Excess/restoration plans
- Elective deferred compensation plans
- Change in control/severance agreements
- Post-termination payments, benefits and other perks
- Gross-ups
- Indemnifications
- Cash incentive and bonus programs
- Reimbursements/payments for taxable items (e.g. country club dues)

- Severance pay programs
- Phantom stock and restricted stock units (deferred stock)
- Options and stock appreciation rights
- Dividend equivalents
- Employee stock purchase programs
- Split-dollar arrangements
- Commissions
- Any other arrangements under which payment could be made more than 2-1/2 months after the year in which the payment right is earned

Note, though, that Section 409A generally does *not* apply to any deferred compensation/benefits that were earned and became nonforfeitable (that is, fully vested) before 2005 (unless they have been materially changed).

What Should You Do?

Because the compliance process could be time-consuming (depending on the number and variety of covered arrangements involved), employers should begin the process as soon as possible,

if they have not done so already. You should confirm with your company's benefits personnel that the following have been, or will be, done **by the end of 2008**:

1. Inventory/identify all compensation/benefit programs, agreements or other arrangements potentially subject to Section 409A.
2. Review each arrangement for documentary compliance and prepare needed amendments.
3. Obtain necessary Board or other internal approvals and, where individual agreements are involved, negotiate any needed changes.
4. Implement changes and review internal HR/payroll processes to ensure all covered arrangements are being operated in accordance with the operational rules and requirements under the final regulations (which include following an arrangement's written terms).

We welcome the opportunity to assist you in meeting these year-end requirements and in complying with Section 409A.