

FINAL SECTION 409A AMENDMENT DEADLINE IS DECEMBER 31, 2008

By Eric D. Swenson, Esq. and
Matthew D. Short, Esq.
Procopio, Cory, Hargreaves & Savitch LLP

The following concerns an important requirement of tax law which, if not satisfied by December 31, 2008, may result in substantial taxes, penalties and interest to employees and other service providers, as well as additional reporting and withholding requirements for employers.

SUMMARY

Unless certain requirements are met, Internal Revenue Code Section 409A provides that employees participating in deferred compensation arrangements will be subject to current taxation (plus possible penalties and interest) on the amount of the deferred compensation. After a couple of extensions by the IRS, the transition period for compliance with Section 409A finally expires on December 31, 2008. Compensation arrangements subject to Section 409A must be amended to comply with the final regulations under Section 409A no later than December 31, 2008. **Accordingly, all employers should immediately review their existing compensation arrangements to determine whether those arrangements require amendment prior to the end of this year in order to comply with Section 409A.**

ARRANGEMENTS SUBJECT TO SECTION 409A

The scope of Section 409A extends far beyond arrangements labeled as "deferred compensation" agreements. The following are types of arrangements, among others, that are potentially subject to Section 409A:

- Employment agreements
- Change-in-control and severance agreements
- Stock option plans and agreements



ERIC D. SWENSON



MATTHEW D. SHORT

- Stock appreciation rights, restricted stock agreements, employee stock purchase plans and agreements, and other equity awards for compensatory purposes
- Annual bonus and other incentive plans

EXAMPLES

The following are a couple of examples of situations where Section 409A may be violated:

1. On December 15, 2008, Employer awards a bonus to an Employee for services rendered during calendar year 2008. The amount of the award, but not the time in which it is to be paid, is set forth in a written letter to the Employee. In addition, the Employee is given the right to choose the payment date of the bonus. On March 20, 2009, Employer pays the bonus to Employee, a California resident. Because the arrangement is subject to Section 409A and did not set forth the material terms in writing, the payment of the bonus likely violates Section 409A resulting in normal taxation (potentially 35% federal and 9.3% state tax), plus the federal 409A penalty of 20%, and the California 409A penalty of 20%, (i.e., the bonus is taxed in total at the rate of approximately 85%). The violation of Section 409A also creates additional withholding and reporting requirements for Employer.
2. On January 1, 2008, Employer grants Employee a nonqualified stock option

expiring on January 30, 2013, or, if earlier, upon termination of employment. The stock option is granted with an exercise price of less than the fair market value of the Employer's stock at the time of grant (i.e., an in-the money option). The grant of the stock option violates Section 409A. Such stock options in-the-money at grant are taxable in the vesting year, based on the underlying stock's fair market value at year end, less the exercise price, plus the Section 409A penalties as described in example 1. In addition, an increase in the underlying stock's fair market value in each subsequent tax year is also taxable in such subsequent tax year (plus the Section 409A penalties). The violation of Section 409A also creates additional withholding and reporting requirements for Employer.

REQUIRED ACTION

To avoid penalties, compensation arrangements not in compliance with Section 409A and the related regulations must be amended in writing no later than December 31, 2008. Employers should act now to make sure that this important deadline is met.

Please contact us if we may assist you in evaluating your arrangements for compliance with Section 409A and making any necessary amendments.

IRS Circular 230 Notice: In accordance with Treasury Regulations applicable to all tax practitioners, we are required to inform you that any federal tax advice given herein is not intended or written to be used for the purpose of avoiding tax penalties, or promoting to another party any transaction or matter addressed herein.

For more information about Section 409A or related matters, please contact either Eric Swenson at 619.515.3235 or Matt Short at 619.525.3897 or your regular Procopio attorney.