September 24, 2008

# Section 409A Relief Needed

By December 31, 2008, nearly every compensation arrangement maintained for any employee subject to U.S. income tax – regardless of his or her title, compensation or position – must be amended to comply with the deferred compensation rules of Section 409A of the Internal Revenue Code. Operational compliance alone will not suffice; each arrangement subject to Section 409A (and in some cases those that are not) must contain certain technical provisions that reflect Section 409A. If the written arrangement does not comply, each affected employee may face immediate income taxes and a 20% penalty tax (even if the payment has not been received or is ever received), and the employer may have reporting and withholding obligations (the long-awaited guidance on reporting, withholding and income inclusion has not yet been issued and will present a separate compliance and administrative challenge).

Although companies have had since the issuance of the final regulations in April 2007 to amend their arrangements to comply with Section 409A, the regulations are massive in breadth and scope and even the most basic principles continue to be debated among practitioners and, we believe, within the government itself. It is apparent that most companies do not have the resources to review every compensation arrangement, identify the issues, find solutions, obtain the approval of senior management or their boards and have the changes reduced to writing and explained or consented to by the affected employees by December 31, 2008. As corporate America faces its most significant financial challenges since the 1930s, its ability to allocate financial and legal resources, and senior management and board attention, to this daunting and possibly futile effort is significantly compromised in ways not contemplated even weeks ago, and clearly must take a backseat to more pressing matters.

Section 409A has achieved one of its primary goals - a six month delay rule prevents executives of public companies from “jumping ship” to get paid their deferred compensation ahead of others (recent events show that deferred compensation’s perceived tax benefits come with a very significant and real credit risk). Whether Section 409A’s other objectives warrant the costs and resource allocation needed to satisfy the overly technical documentary requirements is questionable, since its fundamental requirements have been successfully implemented by companies in operation without regard to the written terms of the arrangement. Ironically, in the current environment, for many U.S. taxpayers, the immediate payment of deferred amounts with a 20% tax penalty may be a more rational choice than continuing the deferral and living with the risk of non-payment and incurring a future penalty tax under Section 409A.

At this point, it is clear that the government’s mandate of complete and error-free documentary compliance by year end (or ever) is unattainable and unnecessary to achieve its original goals. Treasury and the IRS must take action to delay the documentary compliance requirements of Section 409A. In the absence of a delay, the burden on companies would be significantly eased if the application of the 2008 deadline was limited to the executive officers of public companies (*i.e.*, the Section 16 officers). Moreover, the IRS should announce that good faith efforts to comply with the final regulations, both in form and operation, will be acceptable. America’s corporate resources should be focused on business matters in this critical and uniquely difficult time, without the worry that a vast portion of its workforce will be subject to a punitive and draconian tax on New Year’s Day.

Michael J. Segal
Jeannemarie O’Brien
Ian L. Levin

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