

# CLIENT ALERT

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## Potential for Tax Exposure - and Missed Planning Opportunities - For Those that Fail to Review Executive Compensation Plans

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Significant changes to the taxation of executive compensation have been made recently: specifically, by the Pension Protection Act (PPA) that became law in August 2006, and the final Section 409A regulations released by the IRS in April 2007. Penalties for failure to comply with these new rules are as severe as immediate taxation for the current year, plus taxation for all prior years, plus interest, plus a 20% penalty.

As you may know, beginning January 1, 2005, the old way of taxing deferred compensation was largely eliminated. Nearly all plans that defer compensation – such as employment agreements, SERPs, severance arrangements, and incentive compensation plans – now must meet three new tests to avoid immediate taxation. These new tests control contract provisions re: when monies can be paid, when scheduled payments can be accelerated (if at all), and when the executive must make elections to defer.

The PPA provisions and new regulations add several new wrinkles to these three tests. For example, the PPA imposes new restrictions on funding executive compensation packages for companies that sponsor traditional pension plans. These restrictions could cause issues for companies in transition, or in dealing with financial crises, if not addressed beforehand.

With respect to the new regulations, there are negative and positive developments. On the negative side, the IRS now says that, in some cases, the executive will be taxed immediately on deferred compensation even if the money is not actually or constructively received. Similarly, the IRS clarified that executives must make elections to defer discretionary bonuses before services are rendered, even if bonuses are not announced until after services are rendered. In other words, for some types of bonuses, the executive has to choose whether to defer the bonus

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before s/he knows if s/he will receive one! Plans can be drafted to address those types of issues.

On the positive side, the final regulations clarify the application of Section 409A as it pertains to certain key issues, such as independent contractors, indemnification rights, separation pay, legal releases, and termination "for good reason". The final regulations also clarify types of plans that are exempt from the new law, such as certain types of sick leave, vacation, disability, and medical expense reimbursement plans. Plans that were drafted conservatively in 2005 to comply with what the IRS might do could be "loosened up" based on the new regulations, providing significant compensation planning opportunities.

The next step is to identify your "deferred compensation plans" that are subject to these laws, pinpoint areas of noncompliance or opportunity, and develop strategies to move forward. We would be happy to assist you in this process.

Ms. McCarthy advises clients concerning the federal and state tax, employee benefit, and health care regulatory implications of business decisions, and provides technical tax, ERISA/employee benefits, and health care regulatory assistance in business planning.

If you have questions about executive compensation plans or other issues, please contact Ms. McCarthy at [kim@psh.com](mailto:kim@psh.com).

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