KIRKLAND ALERT
October 2008

The End is Near: Deferred Compensation Plan (IRC §409A) Compliance Required by December 31, 2008

Background. §409A of the Internal Revenue Code and its endless treasury regulations impose strict guidelines on the operation of nonqualified deferred compensation plans. Since its 2004 adoption, companies and executives have been living in a liberal transition period requiring only "good faith" 409A compliance in the operation of deferred compensation arrangements. As with Cinderella, however, at the stroke of midnight on December 31, 2008, this fairy tale existence ends and the stark reality of full 409A compliance begins.

What Does This Mean? Effective January 1, 2009, all deferred compensation arrangements not only must be operated in compliance with 409A, they must also comply in form with 409A's arcane and Byzantine provisions. In other words, a deferred compensation arrangement will violate 409A if it doesn't comply in form with 409A before January 1, 2009, even if participants haven't actually received payment of any deferred compensation.

Why Does This Matter? If a deferred compensation arrangement fails to comply with 409A (either in form or operation), participants will be subject to serious tax penalties (including 20 extra points of tax, i.e., a 55% top rate rather than 35%) when their rights to the compensation vest for tax purposes. Considering the inverse relationship between employee happiness and applicable tax rates, it is very important for companies to review their arrangements to insure that they have, to the extent necessary, been brought into 409A compliance by December 31, 2008. Moreover, a company, although not itself subject to penalty, is required to report all 409A violations.

What Should Be Done? The first step to ensure 409A compliance is to review and evaluate every deferred compensation arrangement that could be covered — both at the fund level and at the portfolio company level. These arrangements include:

- Employment, consulting, severance and change in control agreements.
- Equity incentive plans and underlying equity grants, including stock options and SARs.
- Cash bonuses and similar incentive plans.
- Fringe benefits, expense reimbursements and similar programs or policies.
- Foreign plans with United States taxpayer participants.
- Any other deferred compensation arrangement (such as a SERP or other nonqualified pension program) with amounts or benefits earned in one tax year and paid in a future tax year.

Once all potentially covered arrangements have been reviewed, those not 409A compliant must be amended by December 31, 2008, frequently by revising the terms to fit one of the many horrendously complex regulatory exemptions. This can be time consuming, requiring board approval and negotiation with individual executives. Accordingly, we recommend commencing this painstaking process well in advance of the December deadline.

Hasn't This Deadline Been Extended Before? Yes, but absent an extraordinary and unexpected event, the end is near — the December 31, 2008, deadline is not likely to be extended.

Should you have any questions about the matters addressed in this Alert, please contact the following Kirkland & Ellis authors or the Kirkland & Ellis attorney you normally contact:

Scott D. Price
Kirkland & Ellis LLP
Citigroup Center
153 E. 53rd Street
New York, NY 10022
sprice@kirkland.com
+1 (212) 446-4851

Howard M. Klein
Kirkland & Ellis LLP
Citigroup Center
153 E. 53rd Street
New York, NY 10022
hklein@kirkland.com
+1 (212) 446-4730

This publication is distributed with the understanding that the author, publisher and distributor of this publication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this publication may constitute Attorney Advertising.

© 2008 KIRKLAND & ELLIS LLP. All rights reserved.

www.kirkland.com