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ClientAdvisory

Final Section 409A Regulations Issued

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The U.S. Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") have published final regulations (the "Final Regulations") under Section 409A of the Internal Revenue Code of 1986, as amended ("Section 409A"), which impose strict timing and form of payment requirements on all covered deferred compensation. The Final Regulations become applicable on January 1, 2008, but may be relied upon as early as April 17, 2007.

Treasury and IRS officials have stated that, currently, they do not intend to extend the January 1, 2008 deadline. As a result, prompt action is required to ensure timely operational and documentary compliance with Section 409A.

This Client Advisory summarizes some of the basic requirements of Section 409A and the Final Regulations by providing an outline of Section 409A, who may be impacted by these rules, and why compliance is important. In addition, this Client Advisory includes a checklist which may be useful to our clients in identifying many of the deferred compensation arrangements that need to be reviewed, and perhaps amended, in light of the Final Regulations. Because Section 409A covers such a broad range of compensation arrangements, this Client Advisory does not address every issue arising under Section 409A. Rather, we have focused on the areas of Section 409A that we believe may be of particular interest or concern to our clients. Due to the complexity of the Final Regulations, we encourage you to contact us for specific assistance both in working through the checklist and with compliance under Section 409A.

Background

Section 409A was adopted as part of the American Jobs Creation Act of 2004 and became effective on January 1, 2005. Section 409A affects a broad range of non-qualified deferred compensation arrangements, and noncompliance may result in the imposition of substantial tax penalties. Since its enactment, Treasury and IRS have permitted "service providers" (*e.g.*, employees, independent contractors, non-employee directors, partners) and "service recipients" (*e.g.*, employers, companies, partnerships) to achieve compliance with Section 409A by demonstrating "good faith" compliance with the statute. However, beginning January 1, 2008, the good faith compliance standard will no longer apply, and all covered plans and arrangements must be in compliance with the Final Regulations to avoid Section 409A's tax penalties. The "good news" is that the Final Regulations generally offer much more flexibility than the proposed regulations in structuring deferred compensation arrangements to either be exempt from or comply with Section 409A.[1]

Checklist

There is much to be done to prepare for full compliance with the Final Regulations. The following is a brief checklist of the steps that service recipients (and, in some cases, service providers) may want to take in addressing the requirements under the Final Regulations.

Step 1: Identify all arrangements that may be considered deferred compensation.

- Section 409A generally applies to any plan, arrangement or individual agreement (even if not in writing) that promises to pay or provide benefits in a future year. In general, a "deferral of compensation" occurs if, during a taxable year, a service provider has a "legally binding right" to a payment that, pursuant to the terms of the plan or arrangement, may be paid in a later taxable year.

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[1] The proposed regulations under Section 409A were issued October 4, 2005, but were changed in many material respects by the Final Regulations.

- Many arrangements that one would not typically consider to be deferred compensation are treated as such under Section 409A. Consider the following list (which is not exhaustive) of arrangements that could be subject to Section 409A:
  - Elective Salary Deferral Plans
  - Bonus Deferral Plans
  - Bonus or Incentive Plans (Annual or Long-Term)
  - Supplemental Executive Retirement Plans (SERPs)
  - Excess Benefit Plans
  - Individual Employment and Severance Contracts
  - Change in Control Plans
  - Severance Pay Plans
  - Certain Stock Options
  - Certain Stock Appreciation Rights (SARs)
  - Restricted Stock Units (RSUs)
  - Phantom Stock Awards
  - Deferred Stock
  - Section 457(f) Plans

Step 2: Determine whether any Section 409A exemptions are available for the deferred compensation arrangements that have been identified.

- There are only a handful of exemptions from Section 409A (which are briefly discussed below), but they offer a great deal of flexibility if they apply.
- The exemptions will not necessarily be applied to an arrangement as a whole. In many cases, each item of deferred compensation will need to be reviewed separately to determine whether an exemption may apply – even if all the items are provided under a single agreement or plan document. For example, in a severance arrangement, each component of the severance (*e.g.*, cash severance payment, continued welfare benefits, outplacement, additional perks, legal fee reimbursements, indemnification rights, tax gross-up payments) will need to be examined to determine whether it is subject to (or exempt from) Section 409A, as some components may be exempt while others will need to comply with the Section 409A payment rules.

Step 3: Deferred compensation arrangements that are not exempt from Section 409A may need to be amended to comply with the Final Regulations – this may be the case even if they were amended to comply with the proposed regulations under Section 409A. There is no "one size fits all" solution for bringing deferred compensation arrangements into compliance with Section 409A.

- For some arrangements, Section 409A compliance may require some simple (but essential) amendments to an agreement or a plan document. However, not all amendments will be simple, and often they will require business decisions to be made by, for example, plan administrators, board members and/or officers of the company. Amendments will commonly need to provide for payment dates, payment schedules and/or permissible events triggering payments (*e.g.*, death, disability, separation from service), along with the applicable form of payment (*e.g.*, cash, stock).
- There may also be numerous ancillary documents that will need to be revised, such as summary plan descriptions, prospectus documents, election forms, and award agreements.
- In some cases, the plan documents may not require many changes, but the rules and procedures of the person(s) administering the plan or arrangement may need to be revised to comply with the Final Regulations.
- Public companies with deferred compensation arrangements may need to develop a methodology for identifying their "specified employees." As explained below, specified employees generally must wait six months before receiving deferred compensation payments or benefits made in connection with termination of employment.

Step 4: Allow time and expect the need for coordination with various constituencies.

- The process will necessarily take time and cooperation by: companies sponsoring these arrangements (probably requiring time of the human resources, legal and finance departments); compensation committees and boards of directors; the legal, tax and accounting advisors to companies sponsoring these arrangements; and, to some extent, the individuals participating in these arrangements (particularly if the applicable documents require their consent to make the desired amendments).

Why We Care About Section 409A – The Impact of Noncompliance

Service Provider Perspective. Failure to satisfy the requirements of Section 409A results in the service provider who is to receive the deferred compensation immediately owing income tax on the deferred compensation (regardless of whether the compensation has even been paid), plus an additional 20% income tax, *plus potential interest and penalties* for failure to timely remit the income taxes (*e.g.*, if an arrangement were established in January 2006, and the Section 409A violation occurs in September of 2008, interest and penalties could potentially run from January 2006 when the arrangement was first effective).

In addition, the immediate taxation and additional tax, interest and penalties may not be limited to the one arrangement with respect to which the violation occurs. Section 409A aggregates deferred compensation arrangements of a similar kind into single categories, as discussed below. A Section 409A violation with respect to one arrangement will also taint any other arrangements between the service provider and service recipient in the same category. These aggregation rules ensure that Section 409A provides a real deterrent to manipulating the timing (or form) of payment of deferred compensation. Otherwise, an individual may decide that the benefit of receiving the compensation earlier (or deferring it to a later date) outweighs the Section 409A penalty. However, this also means that the risk for inadvertently violating Section 409A becomes greater, because one misstep can cause repercussions beyond the arrangement at hand. Moreover, Section 409A offers neither a de minimis exemption, no matter how small, nor a means of correcting a violation – even an unintended violation which is discovered in the same tax year that the violation occurred.

Service Recipient Perspective. If the Section 409A tax is imposed upon the sevice providers entitled to the deferred compensation (not the companies paying it), many plan sponsors may question why the onus should be on them to take the necessary steps to review these arrangements and bring them into compliance with the new rules. There are a few reasons. One reason is that companies sponsoring (or who are parties to) employee arrangements have an obligation to properly withhold income taxes (and remit them to the IRS or other appropriate taxing agency) on the taxable deferred compensation. In addition, tax law generally requires companies to report any amounts of deferred compensation that it pays to its employees and other service providers. In order for a company to comply with these withholding and reporting obligations and thereby avoid the imposition of penalties and additional tax liability, the company must be able to identify when and to what extent the deferred compensation becomes taxable to the service provider. In addition, companies may want to avoid the negative effect on employee morale that would likely result from the additional liability employees would incur as a result of violating Section 409A.

Aggregation Rules. The Final Regulations provide that all non-qualified deferred compensations plans will be broken down into one of nine categories—with all plans in a single category deemed to be a single plan for compliance purposes. The categories of plans include: (a) account balance plans consisting of participant deferrals, (b) account balance plans consisting of amounts other than participant deferrals (including matches on participant deferrals), (c) nonaccount balance plans, (d) separation/severance pay plans, (e) plans covering amounts related to in-kind benefits or reimbursements of expenses, (f) split-dollar life insurance plans, (g) foreign earned income plans covering primarily nonresident aliens, (h) stock right plans, and (i) deferred compensation plans or arrangements not described above.[2]

- **Example:** A participant is entitled to benefits under two separate plan documents each providing for payment of accounts balances that do not contain participant deferral features (*e.g.*, a phantom equity plan and an accrued bonus plan). If one such plan does not comply with the requirements of Section 409A, then both plans are considered to be non-compliant, and the participant is subject to taxation and penalties under Section 409A.

On the other hand, for purposes of determining taxation and penalties under Section 409A, if a single plan contains payment items that fall into a number of categories, the plan can be disaggregated into several different plans.

- **Example:** If a plan contains severance pay and expense reimbursement benefits, and the severance pay is determined to violate Section 409A, the reimbursement benefits are examined separately to determine whether they violate Section 409A. The failure with respect to the severance pay does not automatically taint the reimbursement arrangement, because it falls into a different category from the severance pay.

Section 409A Exemptions

1. Short-Term Deferral Exemption

The Final Regulations provide that a "*short-term deferral*" is *<u>not</u> a deferral of compensation*. Thus, payment of an amount that is a short-term deferral will not be subject to Section 409A.

There are *two conditions* for short-term deferral treatment: (1) the plan under which the payment is made does not provide for a payment to be deferred to any date or event that will or may occur later than the end of the "applicable 2-1/2 month period," and (2) the service provider actually or constructively receives the payment, so that it is includible in income within the "applicable 2-1/2 month period." The "applicable 2-1/2 month period" is generally the period ending 2-1/2

[2] This Client Advisory frequently uses the term "plan" when referring to any deferred compensation arrangement, including a plan, agreement, arrangement or other promise to pay deferred compensation. Similarly, the term "participant" may be used when referring to the broader term of "service provider."

months after the end of the service provider's (or service recipient's, if later) taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture (i.e., vested). If the payment is not subject to a substantial risk of forfeiture (*e.g.*, is not subject to a vesting schedule or is promised to be paid), payment is vested in the taxable year in which the service provider first has a legally binding right to the payment.

- **Example:** On September 15, 2007, a company and its manager of a sales office enter into an agreement to pay the manager a bonus of 10% of all sales closed from October 1 through December 31, 2007, to be paid after sales figures are finalized in January 2008. The bonus is calculated and paid in February 2008. The payment will be a short-term deferral, which will not be subject to Section 409A.

Use of the short-term deferral exemption may not be so straightforward. The following rules must be kept in mind:

- Each separate "payment" under a plan must be analyzed separately to determine whether the short-term deferral exception applies to the payment. To be a separate payment under the Final Regulations, an amount must be "separately identified," that is, objectively determined under a nondiscretionary formula. The "10% of all sales closed from October 1 through December 31, 2007" in the Example above would be a separate payment.
- Care must be taken to determine whether the plan provides for a deferred payment, for, if it does, the short-term deferral exemption does not apply. If the plan provides that payment will be made at any time which could occur later than the end of the applicable 2-1/2 month period (regardless of whether it actually does), the plan provides for a deferred payment subject to Section 409A.
  - **Example:** A plan provides for an automatic deferral of 10% of total compensation for each year, to be paid upon termination of employment. Employee A has amounts deferred for 2007, 2008 and 2009, then terminates employment on January 31, 2010 and receives a lump sum payment of the deferred amounts. Even though the amount deferred for 2009 is paid out within the applicable 2-1/2 month period, the short-term deferral exception does not apply.
- If a plan provides for a separate "payment" to be made in multiple installments (such as annual installments or a life annuity) one or more of which is deferred to a date beyond the end of the applicable 2-1/2 month period, all installments of the payment would be considered deferred compensation not covered by the short-term deferral exception.
- Finally, *in some cases, a delay in payment may not be fatal*. If a payment that was required to be paid within the applicable 2-1/2 month period is paid after the end of such period, and the delay is because (i) making the payment would have jeopardized the ability of the service recipient to continue as a going concern, (ii) it was administratively impracticable to make the payment within that period (and such impracticability was unforeseeable at the time the service provider received a legally binding right to the compensation), or (iii) the service recipient would not be allowed a deduction with respect to the payment on the designated date due to the application of the Code Section 162(m) limit on employee remuneration (and such application was unforeseeable at the time the service provider received a legally binding right to the compensation), the payment may still qualify as a short-term deferral, provided that the payment is made as soon as it no longer jeopardizes the business, becomes administratively feasible or would be not be subject to the Section 162(m) limitations.

2. *Exemption for Certain Stock Rights*

A. General Rules

Coverage. The Final Regulations *exclude* from coverage under Section 409A "non-discounted" non-statutory stock options and "non-discounted" stock appreciation rights that (i) are issued on service recipient stock (see discussion of "*Service Recipient Stock*" below), and (ii) do not include a feature providing for the deferral of compensation beyond the date of exercise. This exclusion is referred to as the "stock rights exemption." For this purpose, "non-discounted" means that the exercise price of the stock right may never be less than the fair market value of the underlying stock on the date of grant (see discussion of "*Stock Valuations*" below). Also excluded from coverage are statutory stock options (i.e., incentive stock options and options granted under a tax-qualified employee stock purchase plan). However, if a statutory stock option is modified and the stock option, as modified, no longer qualifies as a statutory stock option, the option may be treated as subject to Section 409A from its original grant date.

Modifications. The Final Regulations *generally provide that a modification of a stock right is considered to be the grant of a new stock right*. Whether the new stock right is subject to Section 409A is determined on the grant date of such new stock right. On the date of the modification, an analysis must be completed to determine whether the options remain non-discounted. The Final Regulations specifically provide that *the following are <u>not</u> treated as modifications*:

- Shortening of the period during which a stock right is exercisable.
- Addition of a feature providing for the ability to tender previously acquired stock, or the withholding of stock from the exercise of the stock right, for purposes of paying the exercise price, employment taxes or withholding taxes.
- Exercise by the option's grantor (*e.g.*, the plan administrator) of discretion specifically reserved under the stock right with respect to transferability of the stock right.

Extensions. The Final Regulations *generally provide that the extension of the exercise period of a stock right will be treated as creating an additional deferral feature* as of the original grant date, resulting in the stock right becoming subject to Section 409A from the original grant date. However, the Final Regulations now provide flexibility in this respect, as described below. A stock right is also considered to be extended (resulting in the stock right becoming subject to Section 409A as of the original grant date) when the stock right is converted into or exchanged for a legally binding right to compensation in a future year or when a deferral feature is actually added to the stock right. The Final Regulations provide that *the following will not be treated as extensions of a stock right*:

- Extension of the exercise period until the end of the original maximum term of the stock right or 10 years from the original grant date of the stock right, whichever is earlier.
- Extension of a stock right that is underwater (*i.e.*, the exercise price exceeds the fair market value) on the date of the extension.
- Tolling of the expiration of the stock right during the period that the stock right cannot be exercised without violating applicable Federal, state or local laws, or without jeopardizing the ability of the service recipient to continue as a going concern, but only as long as the tolling period does not extend beyond the 30th day following the date these conditions cease to exist.

Substitution or Assumption due to Corporate Transaction. The Final Regulations provide that stock rights substituted or assumed due to a corporate transaction will not be treated as modified for purposes of Section 409A, as long as such substitution or assumption is in accordance with the adjustment rules applicable to incentive stock options. The Final Regulations further clarify that this rule will apply even in the case of a holder who is not employed by the successor entity.

Other Rules. The Final Regulations adopt a number of additional rules that apply to stock rights, including the following:

- The right to a payment of any dividends or other distributions declared and paid between the grant date and the date of exercise on the shares underlying the stock right generally will be treated as a reduction in the exercise price of the stock right, causing the stock right to become subject to Section 409A, unless the accumulation and payment of dividends is not contingent on the exercise of a stock right and otherwise complies with the requirements of Section 409A.
- A stock right that is a tandem right — an arrangement that provides for two rights (*e.g.*, an option and an SAR) where the exercise of one right terminates the other right — will not, by the mere fact that it is a tandem right, be subject to Section 409A.
- A stock right that provides for the deferral of gains receivable upon exercise will be subject to Section 409A. An amendment of a stock right to provide for such gains will likewise result in the stock right becoming subject to Section 409A from the original grant date of the stock right.
- Because an option that contains a deferral feature is subject to Section 409A (regardless of whether the deferral feature is utilized), any such option will not satisfy the requirements of Section 409A if it can be exercised in more than one taxable year.
- A stock right does not provide for the deferral of compensation merely because it provides for the right to receive substantially non-vested stock upon exercise.
- Amending a stock right to give the grantor the discretion to provide the holder with an additional benefit under the stock right that would constitute a modification or extension would, in and of itself, constitute an extension or modification as of the date of the amendment.
- A change to the terms of a stock right is not considered a modification or extension to the extent such change is rescinded by the date the stock right is exercised or the last day of the service provider's taxable year during which such change occurred, whichever is earlier.
- The grant date of a stock right is the date on which the grantor completes the corporate action fixing the number of shares and exercise price under the stock right, designating the recipient of the stock right and identifying the class of stock underlying the stock right.

B. Service Recipient Stock

"Service recipient stock" is the stock which must be used in a stock right award to qualify for the stock right exemption. Stock rights granted on stock which is not service recipient stock will, under the Final Regulations, be subject to Section 409A. In order to qualify as service recipient stock, the stock must meet the following requirements:

- Any class of common stock may qualify as service recipient stock for both publicly-traded and privately-held companies, regardless of aggregate outstanding value, transferability restrictions or buyback rights. However, while such class of stock may not contain a preferred dividend right, liquidation preferences are permitted.
- Where the service recipient is a group of affiliated corporations or other entities, the final regulations allow service recipient stock to be issued by the corporation which is the service recipient, or any corporation which owns (directly or indirectly) a controlling interest in the service recipient. The "controlling interest" threshold has been dropped from 80% to 50%. In addition, "controlling interests" can be as low as 20% where there are legitimate business criteria, using a facts and circumstances test. Here, the key question is whether there is a sufficient nexus between the service provider and the entity receiving the services for the grant to serve a legitimate non-tax business purpose.

Application to Non-Corporate Entities. While the stock rights exemption is limited to stock rights issued by corporations, the preamble to the Final Regulations provides that, pending issuance of further guidance, equity rights in non-corporate entities (e.g., partnerships and limited liability companies) may qualify for this exemption if they are treated in a manner which is analogous to stock rights issued with respect to corporations.

C. Stock Valuations

The stock rights exemption under Section 409A requires that the exercise price for the stock right may never be less than the fair market value ("FMV") of the underlying stock on the date the stock right is granted. For stock appreciation rights ("SARs") purposes, the "exercise price" generally means the base value of the underlying stock on which the appreciation is measured to determine the amount payable under the SAR. Service recipients may use one valuation method to establish the exercise price or base value for a stock right, and another method to establish the payment amount (for SARs) or repurchase value amount (for stock that is subject to a repurchase requirement), *provided that a single method is used for each separate action*. Under the Final Regulations, once an exercise price, base value or repurchase value is established, the exercise price, base value or repurchase value may not be changed retroactively through the use of another valuation method.

Publicly-Traded Stock. For stock that is "readily tradable on an established securities market," (i.e., public) the FMV of the stock *generally must be determined based on a contemporaneous price established in the securities market*, subject to certain modifications. According to the preamble to the Final Regulations, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in the stock. The value of the stock may be based on the last sale before or the first sale after the stock right grant, the closing price on the day before or the day of the grant, or any other reasonable method using actual stock transactions reported by the market.

Alternatively, *a service recipient may establish FMV by using an average selling price during a specified period that is within 30 days before or 30 days after the date of grant*. The commitment to establish the exercise price or base value using an average selling price must be made irrevocable before the measurement period begins. To satisfy this requirement, before the beginning of the specified averaging period, the service recipient must designate the recipient of the stock right, the number of shares covered by the stock right, and the method for determining the exercise price or base value, including the period over which the averaging will occur.

Privately-Held Stock. For stock that is "not readily tradable on an established securities market," the FMV of the stock is to be *determined using a reasonable application of a reasonable valuation method*. The facts and circumstances indicate whether (i) a valuation method is reasonable and (ii) the application of a valuation method is reasonable. The Final Regulations provide some detail regarding the factors to be considered. According to the preamble to the Final Regulations, the service recipient is *not required to use an independent appraiser* to determine FMV. However, as a practical matter, the use of an independent appraiser may be the safest and most defensible approach.

Under a *safe harbor* contained in the Final Regulations, *a stock valuation is presumed to represent the FMV of the stock unless it is rebutted by a showing that either the valuation method or the application of such method was grossly unreasonable*. The safe harbor applies if the valuation is determined using *one of three methods*: (i) an independent appraisal; (ii) a generally applicable repurchase formula that would be treated as FMV under Code Section 83 (for compensatory or noncompensatory purposes); or (iii) in the case of illiquid stock of a start-up corporation, a valuation by a qualified individual or individuals performed at a time when the corporation does not anticipate a change in control event within 90 days or a public offering of the stock within 180 days following the action to which the valuation is applies.

Time and Form of Payment

1. General Rules

Section 409A deferred compensation (i.e., deferred compensation for which an exemption does not apply) may *be payable only upon the following: a separation from service, disability, death, a change in control, an unforeseeable emergency, or at a specified time (or pursuant to a fixed schedule)*. In addition, Section 409A provides specific definitions and rules for most of the permissible payment dates or events.

The Final Regulations clarify that, with some exceptions, *a single time and form of payment must be designated with respect to each payment of deferred compensation* that is payable upon a payment event.

- **Example:** A plan may provide that deferred compensation is paid in a lump sum upon a change in control, but will be paid in annual installments upon a separation from service. However, the plan may not provide for a lump sum payment upon an involuntary separation from service and installments upon a voluntary separation.

Section 409A generally prohibits the acceleration of payments under a deferred compensation plan. The Final Regulations clarify that payments that offset, or result in a reduction of, the amount of deferred compensation to be paid to a service provider could be considered an acceleration of payment. Thus, service recipients should carefully *review any offset provisions in their deferred compensation plans*, and any plan provisions permitting the sale, transfer, assignment, or attachment of deferred compensation.

Under limited circumstances, the Final Regulations *permit payment of deferred compensation to be delayed to a date subsequent to the designated payment date*. For example, subject to the requirements set forth in the Final Regulations, payment of deferred compensation may be delayed if (i) the service recipient would not be allowed a deduction with respect to the payment on the designated date due to the application of Section 162(m) of the Code, (ii) the payment would violate federal securities laws or other applicable law, or (iii) payment would jeopardize the ability of the service recipient to continue as a going concern.

In addition, Section 409A *permits a subsequent election to delay a payment or change the form of payment of deferred compensation*. As discussed above, "payment" refers to each separately identified amount to which a service provider is entitled under a deferred compensation plan on a determinable date. Life annuities and installment payments (unless the plan provides otherwise), are treated as a single payment.

A subsequent deferral election cannot be effective until at least 12 months after the date on which the election is made, and, in the event of payment on account of separation from service or change in control or upon a specified date or pursuant to a fixed schedule, the payment with respect to which such election is made must be deferred for a period of not less than 5 years from the date the payment would have otherwise been made. Any election related to a payment at a specified time or pursuant to a fixed schedule must be made at least 12 months before the payment is scheduled to be paid.

2. Separation from Service

A plan may allow for payment of deferred compensation upon a service provider's "separation from service." For purposes of Section 409A, a "separation from service" is more than a mere termination of the service provider's employment. As a result, if a service provider has a termination of employment, but continues to provide services to the service recipient (e.g., as a consultant to the company), amounts paid in connection with the termination of employment may trigger Section 409A penalties, unless payment is delayed until a separation from service occurs. In the case of a public company, payments made on account of an individual's separation from service must be delayed for at least six months if the person is a "specified employee."

A. Specified Employees

On the "identification date" each year, employers whose stock is traded on a public or foreign securities market must determine their "specified employees." Proper designation of specified employees is important, because a distribution from a plan subject to Section 409A to a specified employee due to his or her separation from service cannot begin for at least six months after such separation. Therefore, *public companies will need to consider implementing a process now (if they have not already done so) for designating their specified employees on an on-going basis to ensure compliance with Section 409A*. As discussed below, the Final Regulations offer some flexibility in this regard.

The default "identification date" is December 31, but an employer can designate any date. The same identification date must be used for all plans and should be documented in either the plans or a separate policy applicable to all plans. Any change of the identification date may not be effective for at least 12 months.

Specified employees include the 50 highest paid officers who earn at least $145,000 (for 2007) and employee-owners of at least 5% of the employer's stock, or 1% if they earn over $150,000 from the employer. The compensation test is performed on a controlled-group basis (either worldwide or U.S.), while the ownership test is performed on an employer basis.

For ease of administration, the Final Regulations permit employers to use an alternate method for determining specified employees if the method: (1) is reasonably designed to capture all specified employees; (2) is objective and not subject to an election; and (3) does not result in the identification of more than 200 employees. If the alternative method meets these requirements, the employer will satisfy Section 409A if the employer treats each employee identified using the alternative method as a specified employee. If the list does not include a person who is a specified employee, and if that person has a right to payment without the six month delay, the plan will not comply with Section 409A. Therefore, an employer should ensure that its procedures are designed to capture all specified employees.

Once the specified employees on the identification date are determined, they will be *treated as specified employees for a 12-month period that begins no later than the first day of the fourth month following the identification date*. For example, the list created by a plan with an identification date of December 31 will apply during the 12-month period that begins no later than April 1. An employer may elect to use an earlier beginning date; however, all of an employer's plans must use the same application period, which should be documented in either the plans or a separate policy applicable to all plans. Any change to the beginning date cannot be effective for 12 months.

B. Exclusions for Certain Separations from Service

There are *two exclusions from coverage under Section 409A that are of particular relevance to public companies*. Both exclusions relate to the amounts being due to the specified employee as a result of an "involuntary" separation from service.

One exception makes use of the short-term deferral rule, and requires that all amounts due must be paid no later than 2-1/2 months following the end of the year in which the "involuntary" separation from service occurs. This exception can be of great use to a specified employee who is receiving a lump sum severance payment as a result of his or her involuntary termination, but generally does not work if the severance payments are being made over time.

Under the second exception, even if the severance will not qualify for the short-term deferral rule, a portion of the separation pay owed to a specified employee upon an involuntary termination can be paid before the expiration of the six-month waiting period. Specifically, any separation pay which does not exceed the lesser of two times (2x) (A) the qualified plan compensation limit ($225,000 for 2007, or $450,000 total for 2007) or (B) the individual's annualized compensation for the year preceding the year in which the separation from service occurred, can be paid to a specified employee following an involuntary separation without a six-month delay. However, any amounts exceeding this limit must be delayed for six months.

In order for either of the exclusions to apply, *the separation from service must be "involuntary."* For purposes of Section 409A, involuntary separations generally include any termination that was initiated by the employer. However, if a specified employee initiates his or her own separation from service for "good reason," then such separation may still qualify for treatment as an involuntary termination. The Final Regulations contain extensive provisions relating to whether a separation for "good reason" can be considered involuntary, which adds additional flexibility in structuring severance payment provisions in some cases. The Final Regulations also provide certain *"safe harbor" good reason events* that are deemed to result in an "involuntary" termination for purposes of the exemptions described above. *One area of <u>caution</u> is with respect to <u>making any changes</u> to a "good reason" definition in an <u>existing contract or arrangement</u>, because revising a "good reason" provision to comport with the Final Regulations may not be permissible (even during the current transition period).*

Importantly, if the criteria for a "good reason" separation in the applicable arrangement do not comport with the criteria in the Final Regulations, it is possible that <u>*no*</u> separation (even if clearly initiated by the employer) will be considered involuntary for purposes of the exclusions from Section 409A discussed above. In such a case, if amounts paid upon a "without cause" termination by the employer equal the amounts paid for a "good reason" termination, such amounts will not be eligible for immediate payment under either exclusion described above. Because the separation would not be considered involuntary, the six-month delay would need to be adhered to in order to avoid Section 409A penalties.

C. Reimbursements and Other Additional Payments Following Separation

Reimbursements and Other Separation Payments. The right to receive benefits following a separation from service is excluded from Section 409A coverage under the Final Regulations to the extent that such benefits are excludable from the service provider's income for Federal tax purposes. As an example, the preamble to the Final Regulations indicates that an arrangement to provide health coverage to a terminated employee that is excludable from such employee's income under Sections 105 and 106 of the Internal Revenue Code generally would not be subject to Section 409A.

Additionally, payments and reimbursements for benefits that are not otherwise excludible from the service provider's income for Federal tax purposes may still be excluded from Section 409A coverage if certain requirements are met. Reimbursements to the service provider for the following benefits are *excluded from Section 409A* coverage so long as such reimbursements are provided *no later than the last day of the second calendar year following the year of the separation from service*:

- **Medical Expenses**: Reimbursement for medical expenses are exempt from Section 409A coverage to the extent that medical expenses would be deductible to the service provider under Section 213 of the Internal Revenue Code (determined without regard to the 7.5 percent floor requirement) and are made within the COBRA continuation period applicable for such service provider.
- **Outplacement Services and Moving and Other Expenses**: Reimbursement for outplacement services and moving and other expenses are excludable from Section 409A coverage to the extent that such expenses would be deductible to the service provider as business expenses (or reimbursement for any other expense that would be deductible to the service provider as a business expense).
- **Direct Payment**: Rights to medical expenses, outplacement services and moving and other expenses remain excludable from Section 409A coverage even if such benefits are provided in-kind or paid for directly by the service recipient (and not through a reimbursement arrangement) so long as the requirements for such benefits specified above are met.

Any other rights to benefits, payments or reimbursements that do not meet the requirements for one of the exclusions from Section 409A coverage listed above must be structured to comply with Section 409A in order to avoid penalties.

Tax Gross-Up Payments. Tax gross-up payments are treated as complying with Section 409A if they are paid by the end of the calendar year after the year in which the taxes are paid to the government by the service provider. Existing gross-up arrangements should be modified to ensure this is the case. Additionally, careful structuring of any "true-up" provisions (which are commonly seen in gross-ups) will likely be necessary.

Legal Fee Reimbursements (and other reimbursements). Legal (and other) fee reimbursements made to a service provider by the service recipient will be treated as complying with Section 409A if the following requirements are met: (1) the plan provides an objectively determinable, nondiscretionary description of the expenses available for reimbursement; (2) the reimbursements are for expenses incurred during an objectively and specifically prescribed period; (3) the amount of expenses incurred in one year cannot affect the expenses eligible for reimbursement in another year (except with respect to expenses covered by a health plan); (4) the reimbursement is made before the end of the taxable year following the taxable year in which the expense is incurred; and (5) the right to reimbursement is not subject to liquidation or exchange for another benefit.

Indemnification Arrangements. An indemnification arrangement or insurance policy providing coverage to a service provider and paid for by a service recipient is excluded from Section 409A coverage for expenses incurred and damages paid with respect to a bona fide claim based on actions taken or failures to act by the service provider in his or her official capacity as a service provider to the service recipient.

Legal Settlements. An agreement to which a service provider is a party is excluded from Section 409A to the extent that the agreement provides for payment of amounts obtained as a settlement or award of a bona fide legal claim, or for other expenses incurred in relation to such claim, based on wrongful termination, the Fair Labor Standards Act, worker's compensation statutes or other applicable laws regardless of whether such awards are treated as wages for Federal tax purposes.

3. Change in Control of a Corporation

Plans may allow for payment of deferred compensation upon a change in control of the service recipient *corporation*. The Final Regulations provide several different events that may constitute a change in control: a change in ownership, a change in effective control, and a change in the ownership of a substantial portion of the assets of the corporation.

Change in Ownership. A change in ownership can occur when one person or a group acquires stock that, combined with stock previously owned, controls more than 50% of the value or voting power of the stock of the corporation.

Change in Effective Control. A change in effective control can occur when, during any 12-month period, either (1) any person or group acquires stock possessing 30% of the voting power of the corporation, or (2) the majority of the board is replaced by persons whose appointment or election is not endorsed by a majority of the board.

Change in Ownership of a Substantial Portion of Assets. A change in ownership of a substantial portion of the assets can occur when a person or group acquires, during any 12-month period, assets of the corporation having a total gross fair market value equal to 40% or more of the total gross fair market value of all of the corporation's assets.

It is important to note that a deferred compensation plan may have a definition of "change in control" which is stricter than the definition permitted under the Final Regulations. However, if a plan uses a stricter definition, and subsequently amends the definition to be less strict, an impermissible acceleration may occur—possibly resulting in a violation of Section 409A and the incurrence of penalties thereunder.

In addition, while Section 409A permits payments to occur only *upon a change in control of a corporation*, the preamble to the Final Regulations states that, pending issuance of further guidance, the change in control *rules can apply by analogy to other types of entities* (*e.g.*, partnerships and limited liability companies).

Plan Terminations

In addition to the payment events enumerated above, the Final Regulations permit companies to terminate deferred compensation plans and, for the most part, pay amounts deferred thereunder on an accelerated basis. However, such terminations and payments must follow specific rules set forth in the Final Regulations. Generally, for a deferred compensation plan to be terminated in compliance with Section 409A, the following five rules must be followed: (1) the termination cannot occur during a downturn in the financial health of the company, (2) the company must terminate all plans that would be aggregated with the terminating plan (See "*Aggregation Rules*" above), (3) payment of deferred compensation cannot begin until one year after the company terminates the plan (unless amounts would otherwise have become payable pursuant to the plan without the termination), (4) all payments must be made within two years after the company terminates the plan, and (5) the company cannot adopt a new plan that would have been aggregated with the terminated plan (See "*Aggregation Rules*" above) for a period of three years following the date the plan is terminated.

In certain situations, different rules apply to plan terminations. For example, in the case of a plan terminated in connection with a bankruptcy or corporate dissolution, such termination is permitted under the Final Regulations so long as (1) the termination occurs either within 12 months of a dissolution or with the approval of a bankruptcy court, and (2) deferred amounts are timely included in the participants' income. Also, if a deferred compensation plan is terminated in connection with a change in control, the Final Regulations permit such termination if the company that has the payment obligation (1) initiates and completes the termination within the period beginning 30 days before and ending 12 months after the occurrence of a change in control, and (2) terminates all aggregated plans so that all participants are required to receive their respective deferred compensation within 12 months following the date of such termination.

Section 409A Compliance—Transition Guidance

Previously Issued Transition Relief. As stated above, the Final Regulations became effective on April 17, 2007, but, with certain limited exceptions, they apply only to periods beginning on and after January 1, 2008. Transition relief that has previously been issued by Treasury and IRS generally remains available through the end of 2007. The following is a list of some actions that may be taken before January 1, 2008, which will not be allowed once the Final Regulations become applicable:

- Prior to January 1, 2008, non-qualified deferred compensation plans may be administered in good faith compliance with the provisions of Section 409A and applicable provisions of any guidance issued by Treasury and IRS, even if the provisions of the plan document do not comply with the requirements of Section 409A and the Final Regulations. **Plans subject to Section 409A will need to have documents that comply with the Final Regulations by January 1, 2008.**
- A plan may provide, or may be amended to provide, for new payment elections on or before December 31, 2007, with respect to both the time and form of payment of such amounts. Such elections, however, cannot delay payment of amounts that would otherwise be payable in 2007, nor can such elections accelerate payments into 2007 that would otherwise have become due on or after January 1, 2008.
- Prior to January 1, 2008, a discounted stock option may be replaced with an option that would not have been considered "discounted" at the time of grant.

Actions Which Are Now Impermissible. While prior transition relief generally remains in effect, the Final Regulations list certain actions that may have been permissible under the transition relief, but which are not allowed after April 10, 2007 (the date the Final Regulations were published). Some such actions include the following:

- A stock right granted before April 10, 2007, which is based on stock which would have constituted "service recipient stock" under the transition guidance will continue to be considered "service recipient stock" after January 1, 2008. However, a stock right granted on or after April 10, 2007, which is based on stock that does not constitute "service recipient stock" under the Final Regulations, will not be considered compliant with Section 409A as of January 1, 2008.
- So long as an extension of the exercise period for a stock right was granted solely for the purpose of giving the holder of the stock right an additional period of time within which to exercise the stock right, and such extension was granted prior to April 10, 2007, such extension will not cause the stock right to fail to be exempt from Section 409A. Extensions granted for other purposes, and extensions granted after April 10, 2007, will need to be examined in light of the Final Regulations in order to determine their status under Section 409A.
- For a program established before April 10, 2007 that, under the transition relief, would have permitted an initial deferral election to be made after December 31, 2007 and on or before December 31, 2008, an initial deferral election will be deemed to comply with the initial deferral rules if such initial deferral is made within the plan's established deadline. For a program established before April 10, 2007 that, under the transition relief, would have permitted an initial deferral election to be made after December 31, 2008, an initial deferral election will be deemed to comply with applicable rules if it is made by December 31, 2008.

Penalties for Failure to Comply with Section 409A (Post-Transition). The preamble to the Final Regulations provides that if a plan was operated in compliance with Section 409A during the transition period (*i.e.*, prior to January 1, 2008), but is not amended to be compliant by January 1, 2008, then the plan will be treated as failing to comply with the requirements of Section 409A as of January 1, 2008. The result is that no amounts will be subject to the penalties under Section 409A for tax years ending prior to January 1, 2008. However, the penalty may still be imposed with respect to amounts which are vested as of January 1, 2008, but which remain unpaid on such date. This is because such amounts would then be considered deferred under a non-compliant plan.

Take Action

Employers should **immediately** begin to identify all compensation arrangements which may be subject to Section 409A. All such arrangements must be reviewed to determine whether they qualify for an exemption from Section 409A coverage. If they are subject to Section 409A, they must be reviewed to determine whether they must be amended by December 31, 2007. Employers should begin to act now to ensure compliance with Section 409A. Please contact your Katten attorney or one of the following Katten Employee Benefits and Executive Compensation attorneys for assistance in addressing the Section 409A requirements.

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