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CLIENT ADVISORY

IRS Issues Final Section 409A Regulations

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On April 10, 2007, the Treasury Department issued highly anticipated final regulations (the "Final Regulations") that provide guidance under Section 409A of the Internal Revenue Code. Section 409A, which was signed into law during October 2004 as part of the American Jobs Creation Act of 2004, made sweeping changes to the federal tax laws governing nonqualified deferred compensation and has forced major changes in executive compensation practices.

Until now, employers have faced considerable uncertainty on a host of important issues under Section 409A, which has largely precluded them from making key Section 409A compliance decisions and from amending their plans to comply with Section 409A. The Final Regulations, which make a range of important changes to the Proposed Regulations that were issued during September 2005 (the "Proposed Regulations"), finally allow employers to move forward with the process of making Section 409A compliance decisions and adopting plan amendments.

Unfortunately, the Final Regulations do not extend the transition period for amending plans to comply with Section 409A, so employers will have only until the end of this year to complete their decision-making and adopt amendments. Because of the complexity of the rules (the release containing the Final Regulations is close to 400 pages long), many employers will need to immediately begin work in order to meet the December 31, 2007 amendment deadline.

Discussed below are the general categories of plans that employers will need to review for Section 409A compliance as well as highlights of some of the key changes made by the Final Regulations.

PLANS AND ARRANGEMENTS REQUIRING COMPLIANCE REVIEW

- **SERPs and Traditional Deferred Compensation Plans**

  SERPs and traditional deferred compensation plans will need to be reviewed and amended, as needed, to ensure compliance with the Final Regulations' detailed rules relating to the timing of deferral elections, permissible payment triggers, restrictions on acceleration of payments, and the six-month payment delay required for payments to "specified employees" of publicly traded companies that are triggered by a separation from service.

- **Equity-Based Plans and Awards**

  Although not generally viewed as deferred compensation, stock options and other types of equity-based compensation awards are subject to detailed rules under the Final Regulations. It generally should be possible to design most stock options and other equity-based awards to avoid being treated as deferred compensation under Section 409A, but careful navigation of the rules is required.

- **Severance Pay Plans and Arrangements**

  Although also not generally viewed as deferred compensation, severance benefit arrangements are subject to complex rules under the Final Regulations. Arrangements requiring review include not only free-standing severance pay plans and policies, but also severance arrangements embodied in employment agreements.

- **Bonus Plans and Other Types of Cash Incentive Awards**

  Bonus and other cash incentive awards can constitute deferred compensation under the Final Regulations unless structured so as to be paid out within specified periods after employees earn a vested right to payment.

KEY CHANGES MADE BY THE FINAL REGULATIONS

- **Stock Options**

  — *Exercise Period Extensions*

  In a key change, the Final Regulations substantially revise the standard for determining when the extension of the period during which an option may be exercised would result in a violation of Section 409A. Under the Proposed Regulations, extending an option exercise period beyond the later of the end of the year in which it would have expired or two-and-a-half months after it would have expired generally would have resulted in a violation of Section 409A. Under the Final Regulations, an extension will not violate Section 409A, provided that the extension does not extend the exercise period beyond the earlier of the original maximum term of the option or ten years from the original date of grant of the option.

  — *What Stock May Be Covered by Options Eligible for Exclusion from Section 409A*

  Stock options and stock appreciation rights ("SARs") are generally excluded from coverage under Section 409A if they cover "service recipient stock" and have an exercise price at least equal to fair market value on the date of grant. The Final Regulations generally improve upon the unduly restrictive rules contained in the Proposed Regulations for identifying what stock qualifies as service recipient stock. Under the Final Regulations, common stock qualifies as service recipient stock if it is issued by the corporation for which the relevant employee (or other service provider) is providing services on the date of grant (the "employer corporation") or, generally, any other direct or indirect parent of the employer corporation, provided that there is an unbroken chain of ownership of at least 50% (which may be reduced to as low as 20% if there is a "legitimate business reason") between the employer corporation and the direct or indirect parent corporation. Only common stock can qualify as service recipient stock and only if it qualifies under Section 305 of the tax code as common stock and does not have any distribution preferences (other than preferences for distributions of service recipient stock or upon liquidation of the issuer).

- **Short-Term Deferral Rule**

  The Final Regulations retain the short-term deferral rule exception to Section 409A, but make a number of clarifications. In general, under the short-term deferral rule, if a payment is made not later than two-and-a-half months after the end of the year in which an employee's right to payment ceases to be subject to a substantial

risk of forfeiture (i.e., when it becomes vested), the payment is not subject to Section 409A. The rule does not apply, however, if under some circumstances the payment might, under the terms of the arrangement, be made after the permissible period. One clarification made by the Final Regulations is that conditioning a payment upon the occurrence of an involuntary separation from service (including qualifying "good reason" terminations of employment, as discussed below), constitutes a substantial risk of forfeiture. The Final Regulations also clarify that a series of payments can be bifurcated into those that qualify under the short-term deferral rule and those that do not.

- **Six-Month Payment Delay for Specified Employees of Publicly Traded Companies**

  Section 409A requires that payment of deferred compensation to a "specified employee" upon separation from service with an employer that is a publicly traded corporation be delayed for six months (or, if earlier, until the specified employee's death). The Final Regulations give employers new flexibility in identifying their specified employees. Generally, a specified employee is a "key employee" under the qualified plan rules (i.e., a 5% owner, a 1% owner with compensation greater than $150,000 (indexed), or a corporate officer with compensation greater than $145,000 (indexed)). To avoid the risk of violating Section 409A by identifying an underinclusive group of specified employees, the Final Regulations allow employers to use either of the following alternative methods to identify their specified employees even if the alternative method results in an overinclusive group. An employer may:

  — Delay payment of deferred compensation to all service providers, regardless of whether they are specified employees; or

  — Identify specified employees generally using any reasonable method that is (i) designed to include all specified employees, (ii) is based on objectively determinable standards, and (iii) results in no more than 200 service providers being identified as specified employees. If, however, the alternative method results in a service provider who would otherwise be a specified employee being entitled to a plan payment without the six-month delay, the plan will violate Section 409A.

  If an employer elects to use an alternative method to identify its specified employees, it must use the method for all of its plans subject to Section 409A. The Final Regulations also provide new alternatives for determining the relevant dates and compensation used in identifying specified employees and for identifying specified employees after a corporate transaction such as a merger, spin-off or IPO.

- **Definition of "Service Recipient" for Purposes of Determining a Separation from Service**

  The Final Regulations revise and expand upon the rules in the Proposed Regulations for determining when a "separation from service" (a key permissible Section 409A payment trigger) occurs. The Final Regulations retain the rule that a separation from service occurs when a service provider terminates employment or service with the service recipient, but revises the definition of "service recipient" to include controlled group members determined by using a 50% ownership rule rather than an 80% ownership rule. The Final Regulations also allow service recipients to designate in the plan a percentage of not less than 20% nor more than 80% for purposes of the ownership rule (a "legitimate business criteria" requirement applies for use of a percentage less than 50%). The Final Regulations also allow, subject to certain restrictions, the elective use of the "same desk rule" for purposes of determining whether a separation from service has occurred in connection with the sale of "substantial assets" (examples include a plant or division or substantially all the assets of a business) to an unrelated service recipient and also provide guidance as to the application of the separation from service standard in corporate spin-off transactions.

- **Severance Arrangements**

  As under the Proposed Regulations, the Final Regulations contain detailed rules relating to severance benefit arrangements, much of which relate to how and under what circumstances severance benefits may qualify for exemption from Section 409A. A key benefit of not being subject to Section 409A is that exempt severance benefits are not subject to the six-month delay rule described above. In general, the Final Regulations liberalize the rules contained in the Proposed Regulations and provide new guidance on how in-kind severance benefits, such as reimbursement for country club memberships and corporate aircraft usage, may be provided without violating Section 409A. Highlights are as follows:

  — *Severance Benefits Paid upon an Involuntary Separation from Service*
  The Final Regulations continue to provide an exemption from Section 409A for severance benefits paid on account of an involuntary separation from service, provided that it is paid no later than the end of the second calendar year following the calendar year of termination and subject to a limit equal to two times the lesser of (i) the employee's annual compensation or (ii) the Section 401(a)(17) limit on compensation (currently $225,000). An important clarification made by the Final Regulations is that the exemption can be used even if the severance benefits exceed the limit. Where the limit is exceeded, however, the amount of the excess is subject to Section 409A, including the six-month delay rule (where applicable).

  — *Continued Medical Benefits*
  The Final Regulations continue to provide an exemption from Section 409A for continued medical benefits, which is a common component of severance benefit arrangements. In order to qualify for the exemption, the benefits may not extend beyond the period during which the employee could elect COBRA benefits. In general, this rule represents a narrowing of the exemption provided in the Proposed Regulations, which allowed the continuation of medical benefits for the remainder of the year of separation from service plus two additional years. Because tax-free benefits are excluded from coverage under Section 409A, this exception is not needed where benefits can be provided on a tax-free basis, which generally will be the case if provided by means of a third-party insurance policy.

  — *Reimbursements and In-Kind Benefits*
  The Final Regulations generally continue to exempt from Section 409A the reimbursement of outplacement expenses, actual moving expenses and deductible business expenses, provided that the expenses are incurred by the end of the second year following the year of the employee's separation from service. Significantly, however, the Final Regulations now provide wide latitude to provide almost any post-separation-from-service reimbursement or in-kind benefit in compliance with Section 409A (subject to the six-month delay rule, where applicable). Under the new rules, in-kind benefits such as country club memberships and use of company cars and aircraft generally can be provided in compliance with Section 409A so long as the benefits to be provided are objectively determinable and the amount of benefit provided in one year does not affect the amount of benefit that may be provided in another year.

- **Treatment of "Good Reason" Terminations as Involuntary Separations from Service**

  The Final Regulations add specific rules as to what constitutes an involuntary separation from service and expressly provide that certain separations from service for "good reason" can qualify as involuntary separations from service. In order to so qualify, the good reason termination must occur under bona fide conditions such that the termination

is effectively involuntary. The Final Regulations also include a safe harbor definition of good reason that may be used by employers. The recognition that a good reason termination can constitute an involuntary separation from service is of key importance with respect to the payment of lump-sum severance benefits. If a good reason termination qualifies as an involuntary separation from service, the short-term deferral rule may be relied upon to exclude the lump sum benefit from being subject to Section 409A (and the six-month delay rule).

- **Written Plan Requirement**

  The Final Regulations clarify that, in order for a plan to comply with Section 409A, the material terms of the plan must be in writing. Specific items that must be covered include (i) the amount (or method or formula for determining the amount) being deferred; (ii) the time and form of payment; (iii) if the service recipient is a specified employee of a publicly traded company, the six-month delay rule; and (iv) if the plan allows deferral elections, the conditions under which such elections may be made.

- **Plan Aggregation Rules**

  The Final Regulations expanded the categories of plans to which Section 409A's plan aggregation rules apply. The plan aggregation rules are relevant for purposes of determining, among other things, (i) income inclusions and penalty taxes for failure to comply with Section 409A (a compliance failure with respect to a plan results in all aggregated plans being treated as being noncompliant) and (ii) whether an employee may make an initial deferral election after the start of the year under the exception for an employee's "first year of eligibility" to participate in a plan (aggregated plans are taken into account for purposes of determining whether it is an employee's first year of eligibility). Under the Final Regulations, there are nine categories of plans for purposes of the plan aggregation rules: plans providing for stock rights; separation pay plans; expense reimbursement arrangements and arrangements providing for in-kind benefits; split-dollar life insurance arrangements; foreign plans; nonaccount balance plans; "nonelective" account balance plans (plans that do not provide for participant deferral elections); "elective" account balance plans; and all other plans.

- **Required Effective Date of Amendments**

  The Final Regulations provide that plans may be amended to comply with Section 409A effective as of January 1, 2008. This saves employers from the burden of having to retroactively amend plans to reflect how the plans were operated during the January 1, 2005 to December 31, 2007 transition period. The Final Regulations provide, however, that employers must be able to demonstrate good faith compliance with Section 409A during the transition period.

We hope that you find this brief summary helpful. If you would like more information, or assistance in addressing or commenting on the issues raised in this advisory, please feel free to contact:

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