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TAX DEPARTMENT

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Final Section 409A Regulations: Planning Opportunities and Year-End Compliance

The central message of the final deferred compensation regulations (the "Regulations") under Section 409A of the Internal Revenue Code is that, while they are mostly good (or at least better) news compared to the proposed regulations, they still will require a lot of work to ensure compliance. And the work must be completed by December 31, 2007, or payments made after that date will be subject to a 20 percent excise tax.

The bottom line is that every compensation arrangement (including, for example, employment agreements and severance plans) needs to be reviewed to determine whether it is subject to Section 409A, and amended, as necessary, before year end. This is likely to be a daunting challenge in many cases, given the complexity of the rules and the still unanswered questions regarding their application in some instances. Moreover, in some cases, the amendments required to comply may need to be approved by a company's board of directors, compensation committee, and/or shareholders, meaning the real deadline for documentary compliance could be much earlier than December 31.

This memorandum is not intended to provide an exhaustive review of the Regulations, which in many cases did not change materially from the proposed regulations, but to highlight some of their key elements, and offer observations about some of the areas where problems seem most likely to occur.

Scope of Section 409A and Avoiding It

The Regulations did not reduce the scope of what constitutes a deferred compensation plan thereby continuing to sweep in arrangements that intuitively might not seem to involve the deferral of compensation (*e.g.* employment agreements, severance plans, etc.) The difficulty of complying with Section 409A's complex requirements regarding, among other things, deferral elections and methods and timing of payment makes it advantageous to avoid the statute if possible. The Regulations provide several ways to accomplish this.

Short-Term Deferrals

The Regulations reiterate that an arrangement which provides for payment within 2 months after the end of the year in which the payment is no longer subject to a "substantial risk of forfeiture" (defined as it was in the proposed regulations) is not a deferred compensation plan. This rule will not work if the arrangement *permits* a payment to be made outside of the 2 month window, even if it is actually made within the period. The Regulations did provide some latitude in the use of this rule, by, for example, allowing the period to be delayed past the 2 month deadline if making it would jeopardize the employer's ability to continue as a going concern.

The Short Term Deferral Rule can be used to solve one of the major problems with the proposed regulations under Section 409A, which did not permit a distribution to be made upon a specific event such as an initial public offering. The Regulations provide that such an event can be used to trigger a payment *if* the payment is subject to forfeiture until the event occurs and payment is made within the Short-Term Deferral period after the event occurs. The Regulations also make it clear that a requirement that an event occur for payment to be made may itself constitute a substantial risk of forfeiture under appropriate circumstances. The usefulness of this rule may turn on whether employees are willing to risk non-payment of compensation on an event that may not occur, and may be out of their control.

Some Severance Plans

The Regulations followed the proposed regulations by providing that any payment made following an *involuntary* termination of employment is excluded from Section 409A if payment is completed by December 31 of the second taxable year following termination and the amount payable is no more than twice the lesser of: (i) the terminated employee's pre-termination compensation, or (ii) the compensation limit under Code Section 401(a)(17) ($225,000 for 2007). The Regulations, however, materially relaxed the rules by providing that, if a payment exceeds the two-times limit, only the excess amount is subject to Section 409A. This may be particularly important in the case of key employees of public companies who may now receive this amount without waiting six months following termination. The exclusion only applies where payment is available *solely* due to an involuntary termination and not under a plan providing for a payment upon a voluntary separation from service (including a resignation for "good reason", unless the definition of good reason complies with the Regulations).

The Regulations liberalized the proposed regulations by providing that a "good reason" termination may be treated as involuntary if the facts demonstrate that it was triggered by a "material negative change" in an employee's duties, conditions of employment or compensation. The Regulations also provide a safe harbor definition of good reason which may be used to ensure that the termination is involuntary. Unfortunately, while the safe harbor contains many of the terms often used in employment agreements with senior executives, it requires that the employee give notice to the employer of the contract breach and give the employer at least 30 days to cure the breach. The cure requirement in particular, is likely to be unacceptable to many senior executives, making the safe harbor unavailable in many cases.

Stock Options and Stock Appreciation Rights

The Regulations continue the proposed regulations exclusion for grants of nondiscounted stock options and stock appreciation rights ("SARs") covering "service recipient stock," if the options or SARs have no other deferral features. The Regulations revised the rules governing what constitutes "service recipient stock" and how to value it, as follows:

Valuation

For public companies: any consistently applied method, based on the last sales price on the date of grant; the closing price on the day before or after a grant; and the average sales price for up to thirty days before or after a grant, provided that, to use an averaging approach, an employer must irrevocably determine the recipients of an award and the period over which the right will be valued *before* the averaging period begins, and

For private companies: a reasonable method reasonably applied, taking into account any factors that could influence the price (*e.g.* an anticipated sale or investment of capital). An independent appraisal will be presumed to be reasonable for twelve months, as will a written report valuing illiquid stock of a start-up company by a qualified individual.

Service Recipient Stock

The definition of "service recipient stock" now includes virtually any class of common stock, including common stock that has a liquidation preference (but not a dividend preference). The Regulations also provide that the stock may be issued by the employer or any corporation in a chain running from the employer upward to the parent, provided that each corporation in the chain owns at least 50 percent of its direct subsidiary. The ownership requirement is reduced to 20 percent if there are "legitimate business criteria" to explain a grant by a corporation with that lowered level of ownership.

The Regulations, however, continued to provide that: (i) stock of a subsidiary of the employer cannot constitute service recipient stock, (ii) stock of a corporation whose "primary purpose" is to serve as an investment vehicle can only constitute service recipient stock for its own employees, and (iii) added a new anti-abuse rule which provides, in relevant part, that an entity will be presumed to have been established to avoid Section 409A if its primary source of income or value is the provision of management services to other companies affiliated with it. These rules mean that the not uncommon structure in which employees receive options or SARs with respect to stock of a management or other holding company whose only asset is the stock of an operating company subsidiary will need to comply with Section 409A.

Partnerships

As it has with all previous guidance, the IRS reserved final comment on the application of Section 409A to partnerships and partners, adding that, until such guidance is issued, rights to partnership interests (such as options) issued in connection with the performance of services are to be subject to the same principles as interests in stock. In addition, the IRS has not changed the rule for grants of partnership profits interests that comply with previously issued IRS guidance. In most instances, this means that the grant of a profits interests, whether or not subject to a risk of forfeiture, will not constitute deferred compensation subject to Section 409A.

Other Key Elements of the Regulations

Permissible Distributions Events

The Regulations did not change the rule that distributions from plans subject to Section 409A may be made only: on a participant's death, disability or separation from service; at a specified time or pursuant to a fixed schedule; on a change in control; or on an unforeseeable emergency. The Regulations did provide guidance regarding what constitutes a separation from service (particularly with respect to employees who go on a leave of absence or reduce their working hours), and payment at a fixed time or pursuant to a fixed schedule. With respect to the latter, the Regulations reiterate that an event with an unknown date (*e.g.* a child's graduation from college, consummation of an IPO) is not a fixed time. Instead, amounts must be payable at a time, and in an amount, that can be objectively determined at the date of deferral, under a fixed payment schedule. They also make clear that a payment that is subject to forfeiture unless a specified event (*e.g.* and IPO) occurs before employment terminates, and is payable at a specified time and amount following the event, (*e.g.*, six months following the IPO) if the employee is still employed on such date would not be subject to Section 409A.

Distributions to "Specified Employees"

Distributions to "specified employees" of publicly-traded corporations that would otherwise be payable as a result of a separation form service generally must be delayed for at least six months. The most common specified employees will be officers with compensation in excess of $145,000 per year. As noted above, the Regulations provided some relief in this area by allowing distributions up to two times safe harbor within the six-month period if the termination is involuntary. The Regulations also provide that self-insured medical benefits may be provided for such employees during the six-month period without violating Section 409A.

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Post-Termination Extensions of Option and SARs

The proposed regulations generally limited the time by which a stock option or SAR had to be exercised following termination of employment to the end of the year in which it would have expired. The Regulations extend this limit to the earlier of the end of the original term of the option or SAR and ten years from the date of grant. In addition, an extension of the term of options that are then "underwater" will not violate Section 409A.

Saving Clauses

Many practitioners inserted savings clauses into agreements (particularly employment agreements) after Section 409A's passage, in an attempt to preserve the right to fix any non-complying provision. The Regulations specify that the IRS will ignore such clauses, thereby requiring full compliance in plan terms by December 31. It nevertheless seems likely that most practitioners will advise employers to continue to use such clauses, on the basis that they may have value in a future challenge to an IRS position.

Gross-up Payments

The right to receive a gross-up payment for taxes (*e.g.* for payments under Section 280G of the Internal Revenue Code) is deferred compensation but will comply with Section 409A if the payment is made by the end of the year following the year in which the taxes are paid. This will allow virtually every arrangement to comply since payment is usually made at the latest shortly after the taxes are due.

Plan Aggregation Rules

The Regulations somewhat complicated the rules regarding plans that need to be aggregated under Section 409A by expanding the number of plan categories from four to nine. This, however, means that a failure to comply with respect to one plan is likely to affect fewer other deferred compensation plans.