T O O U R F R I E N D S A N D C L I E N T S

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Worth the Wait? The Final Section 409A Regulations

The Treasury Department has issued final regulations under Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"). Section 409A, entitled "Inclusion in Gross Income of Deferred Compensation under Nonqualified Deferred Compensation Plans," was added to the Code in October 2004 as part of the American Jobs Creation Act of 2004. These final regulations come after proposed regulations issued on September 29, 2005 as well as a succession of interim guidance. After extensions and numerous transition rules, companies now must be in documentary compliance with Section 409A by December 31, 2007.

We have set forth below a short summary of the most significant provisions of the final regulations.

Stock Right Issues

Under the final regulations, options and stock appreciation rights on service recipient stock that are granted at fair market value (and can never have an exercise price lower than fair market value on the date of grant) are eligible for exemption from Section 409A. Key structuring issues related to options and SARs under Section 409A include the following:

- Service Recipient Stock. In order to be eligible for the exemption from Section 409A, stock options and SARs must be granted on "service recipient stock." Service recipient stock (i) must be common stock and must have no preferences other than a liquidation preference and (ii) must be the stock of the entity for which the employee provides services or any direct or indirect parent of that entity in the chain of ownership above the entity, so long as each entity in the chain has a controlling interest in the entity directly below it (for this purpose, the controlled group rules of the Code are applied except that the 80% test has been lowered to 50% (20% if legitimate business criteria are applied)). The final regulations have removed the requirement in the proposed

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regulations that, for a controlled group in which one member was publicly traded, the publicly traded stock is the only stock that would qualify as service recipient stock.

- Valuation. As under the proposed regulations, private companies must reasonably apply a reasonable valuation method to determine the fair market value of the exercise price of their stock rights. For this purpose, an independent appraisal is presumed to be reasonable, as is a valuation evidenced by a written report prepared with respect to illiquid start-ups so long as the start-up is not reasonably expected to undergo a change in control within 90 days or a public offering within 180 days. For public companies, valuation must be based on actual transactions in the common stock.
- Modifications. A modification of a stock option or SAR may be deemed to be the grant of a new option or SAR (such that if the option or SAR is in the money at the time of the modification, the resulting option would be subject to Section 409A). The final regulations provide that it is not a modification for the exercise period of an option to be extended until the original expiration date of the option or the tenth anniversary of the date of grant of the option, whichever is earlier, thereby providing a great deal more flexibility than the limited extension permitted under the proposed regulations.

Exception for Separation Pay

Under the final regulations, certain types of separation pay are not considered deferred compensation and therefore are not subject to Section 409A. For example, if an employee receives limited separation pay due to an involuntary termination, the employee can also receive qualifying reimbursements and the additional limited amount of separation pay without any of those payments being subject to Section 409A. The excluded types of separation pay as described in the regulations include:

- Arrangements providing separation pay due solely to an *involuntary separation from service* (discussed below) or participation in a window program in limited amounts and for a limited period of time;
- Reimbursements arrangements providing for expense reimbursements or in-kind benefits for a limited period of time following a separation from service, including reimbursement of medical expenses for the COBRA period;

- Rights to limited amounts of separation pay which are not otherwise excluded (equal to the maximum amount of an elective deferral permitted under Section 402(g) for the year of the separation from service, which is $15,500 for 2007);
- Foreign separation pay arrangements required under foreign law; and
- Bona fide collectively bargained arrangements without dollar limitation or time restrictions.

Involuntary Separation from Service

Payments upon an involuntary termination under a non-collectively bargained separation plan are excluded subject to numerical and timing restrictions. Payments based solely upon an involuntary separation from service are not subject to Section 409A, to the extent that (a) they do not exceed the lesser of two times (i) the individual's annualized compensation or (ii) the maximum amount that can be taken into account as compensation for qualified plan benefits for the year of the separation of service ($225,000 for 2007); and (b) they are paid by the end of the second taxable year of the employee following the year of the separation of service. The exception does not cover payments that would also be made upon a voluntary separation from service or other event. Where the total amount of severance payments either exceed the threshold or are payable beyond the limited period, only the excess payments and/or amounts payable beyond the permissible payment period will be subject to Section 409A.

Terminations due to good reason provisions as set forth in the regulations may be considered an involuntary separation from service, provided the good reason clause is not designed to avoid Section 409A and the termination involves a material negative change in the employment relationship as a result of actions taken by the employee. The final regulations do provide guidance to companies on how to craft appropriate good reason provisions, including a safe harbor provision.

Reimbursements

The final regulations generally permit companies to provide in-kind Section 409A-compliant benefits and/or reimbursement of in-kind benefits so long as (1) the arrangement covers an objectively prescribed period of time, (2) the in-kind benefits and/or reimbursements provided in one year cannot affect the amount of in-kind benefits and/or reimbursements provided in another year, (3) reimbursements are made no later than the taxable year following the taxable year in which the expense is incurred and (4) the in-kind benefits and/or reimbursements may not be liquidated for cash. The final regulations explicitly set forth the manner in which tax gross-ups (including excise tax gross-ups under Section 280G of the

Code) and related expenses may be structured to comply with Section 409A. The final regulations also clarify that a nontaxable benefit is not subject to Section 409A. The final regulations also exclude from Section 409A a number of specific items with respect to employees who have separated from service.

Plan Aggregation Rules

The legislative history to Section 409A provides that deferred compensation plans should be aggregated, with the effect that a noncompliant deferred compensation arrangement could taint other, compliant deferred compensation arrangements within the same category. The final regulations expand the number of categories within which plans must be aggregated (and thus reduce the risk of taint described in the preceding sentence). The categories of deferred compensation plans now include (1) account balance plans; (2) nonaccount balance plans; (3) separation pay plans; (4) plans providing for grants of stock rights (e.g., stock options, stock appreciation rights and phantom stock); (5) in-kind reimbursement plans; (6) foreign plans (for a plan to fall within this category, substantially all participants in the plan must be nonresident aliens (among other requirements)); (7) split-dollar arrangements; and (8) all other plans not falling into one of the preceding categories. Companies must further bifurcate account balance plans into their elective and non-elective components. Plans in which an individual participates as an employee are treated as separate from plans in which the individual participates as a director or other independent contractor.

Specified Employee – Delay in Payment

The plan document or employment agreement must include the requirement that a payment of nonqualified deferred compensation on account of separation from service to a specified employee may not occur less than six months after the date of separation from service (or if earlier, the date of the death of the employee). For this purpose, a specified employee is a key employee, as defined in the Code, of a corporation any stock of which is publicly traded on an established securities market (including foreign securities markets). Employees identified as key employees on the identification date would become specified employees as of the first day of the fourth month following that date, unless the company provides another date. The six-month delay rule applies so long as the employee is a specified employee on the date of separation from service. To avoid under-inclusion of specified employees, a nonqualified deferred compensation plan may provide that all payments upon a separation from service will commence six months after the separation from service. A plan may also use an alternative method of identification so long as the method selected is reasonably designed to include all specified employees, is an objectively determinable standard not providing any election to the employee, and results in the identification of no more than 200 specified employees. Any plan that fails to include the six-month delay for a single specified employee will not be in compliance with Section 409A.

The final regulations also set forth the method for identifying specified employees in the context of acquisitions by one public company of another public company, by one public company of a private company, and for spin-offs.

The six-month delay rule does not apply to the following:

- Benefits paid due to death, disability, change in control, and/or emergency situation;
- Certain plans that provide for reimbursements or in-kind benefits to terminated employees; and
- Acceleration of payments in compliance with regulations relating to a qualified domestic relations order, to satisfy a Federal, state, local, or foreign ethics law or to pay certain employment taxes.

Payments upon a separation from service that are excluded from the definition of deferred compensation under Section 409A (such as short term deferrals and the limited payment equal to two times either annual compensation or the maximum amount that can be taken into account as compensation for qualified plan benefits upon an involuntary termination), will not be subject to the six-month delay rule (whereas any payments not so excluded will be subject to the six-month delay).

Pension Plan Exception

Generally, Section 409A requires specification of the time and form of payments. It is now acceptable to provide that payments will be in the same form as is elected under a qualified plan, certain broad-based foreign retirement plans and benefit formulas that include a reduction for amounts credited to the employee's account under a tax-qualified plan (including for matching contributions).

Transition Rules

The final regulations become effective on January 1, 2008. Companies may rely on the final regulations immediately, but prior to January 1, 2008, companies will not be penalized provided that they are in good faith compliance with transitional guidance. Documentary compliance needs to be in place by December 31, 2007. However, amendments are not required to reflect actions taken under the transition rules to the extent such amendments or actions do not affect the plan's compliance with Section 409A and the final regulations on or after January 1, 2008. In addition, the requirement to amend plans to bring them into compliance does not apply retroactively for amounts deferred that were paid on or before December 31,

2007, although the company must be able to demonstrate that the plan was operated in good faith compliance with the transitional guidance.

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