

FINAL REGULATIONS UNDER SECTION 409A ON TAXATION OF DEFERRED COMPENSATION

Introduction

In April, the Treasury Department and the Internal Revenue Service (“IRS”) issued 397 pages of the much anticipated final regulations (the “Final Regulations”) under section 409A of the Internal Revenue Code (the “Code”), dealing with the taxation of “nonqualified deferred compensation plans” (“NDC plans”). For the purposes of Code section 409A, a NDC plan encompasses a very broad range of plans, agreements, methods, programs or arrangements by which a “service provider” has a legally binding right during a taxable year to compensation that pursuant to the terms of such plan or arrangement is or may be payable in a later taxable year. The Final Regulations exclude certain types of deferred compensation plans and arrangements from being subject to compliance with Code section 409A; nevertheless, a NDC plan may encompass arrangements that taxpayers may not generally associate with deferred compensation, such as payments for covenants not to compete, severance pay, management fees, tax gross up payments and certain expense reimbursements (although the Final Regulations provide some exceptions for these arrangements). Furthermore, a service provider for Code section 409A purposes includes not only employees or directors, but also certain independent contractors, S corporations, personal service corporations, partnerships, and other entities that provide services and use the cash method of accounting for federal income tax purposes.

A NDC plan generally must be in full compliance with these Final Regulations by December 31, 2007. With the promulgation of the Final Regulations, the IRS reiterated that transitional relief would be available for NDC plans that were operated in good faith compliance with Code section 409A since its enactment and the IRS guidance previously issued, but only if the plans comply with the Final Regulations by December 31, 2007, and are operated in accordance with such Final Regulations thereafter. As a result, in order to comply, certain existing NDC plans may need to be amended. Operational practices with respect to NDC plans may need to change. Moreover, all future NDC plans will need to be documented and operated in accordance with the Final Regulations.

Course of Action

It is recommended that service providers and service recipients review all current deferred compensation plans arrangements as soon as possible and seek appropriate legal and tax advice to ascertain what amendments, documentation, and institutional practices may need to change and/or be implemented. Furthermore, service recipients should make sure they have adequate files and records that would help demonstrate good faith compliance with Code section 409A and the IRS prior guidance with respect to Code section 409A, including documentation that demonstrates how the fair market value of stock options and other equity compensation was determined and written elections of service providers with respect to any deferrals of compensation.

Background

Code section 409A enacted in October 2004, generally provides that, if at any time during a taxable year, a NDC plan fails to meet, or is not operated in accordance with, certain requirements in Code section 409A dealing with (i) distribution and payment, (ii) non-acceleration, (iii) deferral elections and (iv) a six month delay rule for specified employees with respect to publicly traded companies, all compensation deferred under such plan is currently taxable to the service provider as compensation income and subject to an additional 20 percent tax and underpayment interest at an increased interest rate. The Code section 409A taxes are imposed on the service provider, not the service recipient or employer. Nevertheless, an employer or other service recipient whose NDC plans are not in compliance with these Final Regulations may have withholding tax and information reporting obligations in addition to disgruntled officers, directors, employees or other service providers who find themselves unintentionally subject to these draconian tax liabilities. The Final Regulations did not address these withholding tax and information reporting obligations and additional guidance is expected from the IRS. Employers and other service recipients should consult IRS Notice 2006-100 which addressed reporting and withholding for deferred compensation subject to Code section 409A in 2005 and 2006.

The Code section 409A tax rules also apply to certain deferred compensation arrangements that make use of trusts or similar arrangements that are formed outside the United States or

transfers of assets that are dependent on the employer's financial condition. The Final Regulations, however, did not address these aspects of Code section 409A. Transitional guidance with respect to these aspects of Code section 409A may be found at IRS Notice 2006-33, 2006-15 IRB 754. The Final Regulations also reserved on the application of Code section 409A to arrangements between partners and partnerships, directing taxpayers that they may continue to rely on Notice 2005-1, Q&A-7 for guidance in this area. The IRS did reiterate that Code section 409A applies to partnership guaranteed payments with respect to services and that Code section 409A generally does not apply to payments to retiring partners or deceased partners under Code section 736 unless such payments were excluded from self employment taxes pursuant to Code section 1402(a)(10) (with certain temporary deemed Code section 409A compliance granted in such case).

The proposed regulations had also reserved on the treatment of split dollar insurance arrangements. The Final Regulations also do not have specific provisions with respect to split dollar insurance arrangements; however, on the same day the Final Regulations were announced, the IRS announced Notice 2007-34, which provides guidance on the application of Code section 409A to split dollar insurance arrangements. Split dollar arrangements in which the service provider is only entitled to a death benefit and not a right in the cash surrender value or other policy value is not subject to Code section 409A. The Notice also announced that the modification of a split dollar arrangement to comply with the Final Regulations would not be treated as modification that terminates the grandfather status of the split dollar arrangement for Treasury Regulation section 1.62-22 purposes if certain conditions are met.

Code section 409A does not apply to deferred compensation that was vested by December 31, 2004, and earnings thereon (e.g., notional interest, appreciation in value of option), unless the plan is materially modified after October 3, 2004. The Final Regulations provide that the amendment of a plan to comply with the Final Regulations is not a material modification; however, such amendment cannot add new benefits.

Some Important Highlights of the Final Regulations

The rest of this alert summarizes some of the important highlights of the new regulatory guidance. However, bear in mind that the Final Regulations are lengthy, and application to a specific factual circumstance or arrangement requires an in-depth review of the applicable facts of the situation and the application of the law and Final Regulations to those facts. Taxpayers are urged to consult with their tax and legal advisors with respect to the application of Code section 409A to their particular factual circumstances.

No Savings Clause

The Final Regulations emphasize that a "savings clause" will not save a NDC plan from complying with the Final Regulations. Thus, inserting language into a plan that provides something to the effect that in all events the plan will be interpreted and operated in compliance with Code section 409A and the Final Regulations or that no payment or provision will be adhered to which violates the requirements of Code section 409A and the Final Regulations will not save the NDC plan. If that NDC plan fails to meet the necessary provisions of the Code section 409A and the Final Regulations, the deferred compensation in such NDC plan will be subject to the Code section 409A tax treatment.

What is an NDC Plan?

Basically, an NDC plan is any "nonqualified" plan, agreement, method, program or arrangement (oral or written) that provides for a "deferral" of "taxable" compensation, such that the compensation to which the service provider has a "legally binding right" is or may be paid after the year in which it had been earned. Examples include salary or bonus deferral programs, severance arrangements, many forms of equity compensation, programs providing for payment upon a change of control, and employee benefit plans not covered by ERISA (such as supplemental executive retirement plans). The broad definition of a NDC plan means that potentially payments for a covenant not to compete may be treated as a NDC. There are four noteworthy elements noted above in what constitutes a NDC.

- First, an NDC does not include a qualified plan and thus a qualified plan is not subject to Code section 409A. Qualified plans are those plans that are specifically addressed in the Code and the Final Regulations for which Congress has provided special beneficial tax rules, such as those plans governed by ERISA, 401(k)s, Keogh plans, qualified retirement plans, qualified annuity plans, simplified employee pension plans, bona fide vacation leave, sick leave, compensatory time, disability, or death benefit plans, Archer Medical Savings Accounts, Health Savings Accounts under Code section 223, and other medical reimbursement arrangements where the benefits are excludible from gross income under Code section 105 or 106. The Final Regulations also address that certain foreign plans are excluded from the application of Code section 409A.
- Second, there must be a deferral feature, which will be addressed below in greater detail as the Final Regulations contain a number of exceptions for certain

arrangements which generally would be treated as providing “deferral.”

- Third, the compensation must be of a type that would be taxable for federal income tax purposes. Compensation that is excluded from gross income for federal income tax purposes (such as certain fringe benefits) when paid is not subject to Code section 409A.
- Fourth, the service provider must have a legally binding right to the compensation. A service provider does not have a legally binding right to compensation to the extent that the service recipient may unilaterally reduce or eliminate the compensation after the service creating the right to compensation has been performed. However, this element is not avoided by the fact that the compensation may be subject to vesting or certain conditions that are part of the compensation arrangement itself or the fact that the amount of compensation cannot be determined at the time the legally binding right is created, such as a bonus tied to a percentage of profits which cannot be determined until a later period of time.

For the purposes of Code section 409A, a NDC plan is tested on a per employee or service provider basis. Thus, the fact that a payment may be made to one employee that does not comply with Code section 409A and causes the compensation under that employee’s NDC plan to become subject to the additional tax and interest does not mean that other employees who did not receive the prohibited payment with respect to similar NDC plans will have their compensation subject to the Code section 409A taxes. The Final Regulations aggregate certain NDC plans of a service provider and treat the aggregated plans or arrangements as one plan for the purposes of Section 409A. For example, under the Final Regulations, all account plans for which the service provider has a deferral election are aggregated as one plan, while separation pay plans (unless excluded from section 409A) are aggregated and treated as a separate plan, stock rights plan are aggregated and treated as an additional separate plan, and expense reimbursement plans are aggregated and treated as another separate plan. The Final Regulations provide additional rules as well with respect to aggregation of plans.

Deferral

The deferral element has a significant focus in the Final Regulations (as it did in the proposed regulations) because the Final Regulations provide for a number of exceptions or situations that are not treated as creating deferral for the

purposes of Code section 409A. As a result, compensation arrangements that only have a deferral element described in one of these exceptions do not need to comply with the distribution, election, nonacceleration, and 6 month specified employee provisions of Code section 409A to avoid the adverse tax consequences of section 409A. Set forth below is a summary of the most significant of these deferral exceptions.

Short-Term Deferral Rules

Compensation is not treated as deferred for Code section 409A purposes if the plan under which payment is made (i) does not provide for a “deferred payment” within the meaning of the Final Regulations and (ii) the service provider is paid within 2-1/2 months after the taxable year in which the payment is no longer subject to a substantial risk of forfeiture (i.e., generally, is earned and vested). A “deferred payment” is present if the plan provides that any payment will be made or may be made at a point in time which could be outside this 2-1/2 month period, such as at death, disability, or change of control, regardless of whether the payment is actually made within the 2-1/2 month period. The Final Regulations clarify that for the purposes of this 2 -1/2 month exception and Code section 409A, a plan could specify that, with respect to a series of payments, each payment is to be treated as a separate payment such that any payment within the applicable 2-1/2 month period would qualify for this exception even if there are other payments outside the period. The Final Regulations also clarify that, if there were delays in the payment because (i) the payment was administratively impracticable by the service recipient due to an event unforeseeable when the right to compensation developed, (ii) the payment would jeopardize the service recipient’s ability to continue as a going concern or (iii) the making of the payment at such time would give rise to a disallowance of a deduction under Code section 162(m) that could not have been reasonably anticipated when the right arose, do not disqualify the payment from meeting the short-term deferral exception. The Final Regulations also identify that an involuntary separation, which as explained below can now include a voluntary separation for good reason in certain circumstances, may be treated as a substantial risk of forfeiture condition such that the 2-1/2 month exception could be utilized in a situation in which a right to payment does not vest until an involuntary separation or voluntary separation for good reason. For example, a separation pay plan that solely provides a person will be awarded a payment of \$500,000 if involuntarily terminated and that such payment will be made within 2-1/2 months of the end of the service provider’s taxable year in which the employee is involuntarily terminated should not be treated as deferred compensation for Code section 409A purposes.

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Separation Pay Arrangements

The Final Regulations contain a number of exclusions from the deferral rule for certain types of severance arrangements. The Final Regulations clarify that these severance arrangement exclusions may be used in combination such that compensation under a plan that would be exempted under more than one of these exclusions may be treated as exempted under one exclusion to free up another exclusion for other compensation.

- First, payments for separation upon an involuntary termination or pursuant to a “window program,” are exempt from Code section 409A as long as (A) the payments to the service provider do not exceed twice the lesser of (1) the service provider’s annualized compensation based on the annual rate of pay for the year preceding the termination of employment or (2) the qualified plan annual compensation limit under Code section 401(a)(17) (currently \$225,000) and (B) are paid no later than the end of the employee’s second taxable year following the year in which the termination occurs. The Final Regulations clarify that this exclusion can apply to that portion of the payments made within the applicable time period and under the dollar threshold even if other payments fail to qualify under the dollar amount and time period. A payment pursuant to an involuntary separation under the applicable dollar threshold, thus, does not qualify as a deferral to which the Code section 409A rules applies so that it could be paid within the 6 month period for specified employees of public companies. The Final Regulations added that a voluntary termination for good reason may qualify as an involuntary termination for this purpose. The Final Regulations define good reason and provide some safe harbor rules that drafters of plans and severance agreements plan are likely to use going forward.
- Second, separation pay plans that provide for reimbursement of expenses that would have been deductible as trade or business expenses, moving expenses, outplacement, and certain other in-kind benefits that are incurred by the taxpayer no later than the second year following the year in which the separation of service occurred and that are reimbursed by the third year following the year in which the separation of service occurred, or other amounts not to exceed the Code section 402(g) amount (currently \$15,500), are not subject to Code section 409A. Plans to reimburse for medical expenses also are encompassed within this exception if the right to reimbursement applies during the period in which the former employee is eligible to elect COBRA (whether or not the COBRA election is actually made).

- Third, certain foreign separation pay plans and collective bargaining separation pay arrangements are excluded under this deferral exclusion.

Stock Options and SARs

Following the proposed regulations, stock options, phantom stock and stock appreciation rights plans for which the exercise price or base price was not less than fair market value on the grant date and have no other deferral feature also qualify under a deferral exception. The Final Regulations provide extensive guidance on how fair market value can be established for both publicly traded and private company situations, whose stock is eligible to be taken into consideration, and when stock rights and options would be treated as being modified or amended. The Final Regulations liberalized the treatment of extensions of stock rights such that the extension of the term of a stock right will not be treated as an additional deferral feature if the exercise period is not extended beyond the earlier of the original maximum stock right term or 10 years from the original grant date. Furthermore, the extension of a stock right while the exercise price is greater than the fair market value of the underlying stock is not treated as an additional impermissible deferral. The Final Regulations also provided deemed qualification status to certain extensions of stock rights before April 10, 2007.

Indemnification and Liability Insurance Plans, Legal Settlements, Certain Educational Benefit Plans

The Final Regulations also provide that indemnification and liability insurance plans, legal settlements or awards with respect to bona fide claims based on wrongful termination, employment discrimination, worker’s compensation statutes and the Fair Labor Standards Act as long as not a disguised payment of other deferred compensation, and plans that provide taxable educational benefits for the service provider (and his or her family members) also are excluded from being treated as causing deferral for Code section 409A purposes.

Distribution Requirements

If a nonqualified deferred compensation arrangement is not excluded by one of the deferral exclusions and is a NDC plan for Code section 409A purposes, distributions or payments must occur only upon (i) separation from service, (ii) disability, (iii) death, (iv) change in control, (v) occurrence of an unforeseeable emergency, and/or (vi) specified time or fixed schedule of payments. The Final Regulations provide significant guidance and definition to these distribution events (other than death, which mercifully the IRS did not attempt to define). The Final Regulations provide that with certain exceptions, a single time and form of payment may be designated for each distribution event and a plan may have a

payment as of the earlier or later of multiple distribution events. The Final Regulations also specify that a payment period after a distribution event could be designated (rather than a single date) if the period begins and ends in one taxable year of the service provider or the designated period is not more than 90 days and the service provider may not designate the taxable year of payment (other than in compliance with the deferral election requirements). The Final Regulations also permit alternative payment schedules with respect to the disability, death, change in control, or unforeseeable emergency distribution events if the event occurs on or before a specified date. For example, one payment schedule could be specified if disability occurs before the service provider's 55th birthday, while another payment schedule could be specified if the disability occurs on or after the person's 55th birthday. With respect to a separation of service distribution event, alternative time and form of payment may be specified for a separation of service occurring during a limited period of time following a change in control (not to exceed two years) or a specified date (e.g., the attainment of a particular age). The Final Regulations generally provide that a payment is treated as being made on the specified date if it is actually made on such date, a later date in the same taxable year, or, if later the 15th day of the third month following the date specified in the plan if the service provider cannot designate the taxable year of payment. In addition, a payment made no more than 30 days before the specified date is treated as being made on the specified date if the service provider cannot designate the taxable year of payment. Furthermore, the fact that a service recipient fails to make the required payment on the date specified or required because it disputes the payment will not be treated as violating the payment requirement of Code section 409A if the service provider makes a prompt and reasonable good faith attempt to collect the payment and the payment (as adjusted by the dispute) is ultimately made no later than the end of the provider's first taxable year in which a legally binding settlement or final nonappealable judgment is obtained. The following are some additional observations with respect to certain of these distribution events.

Separation from Service

As in the proposed regulations, the Final Regulations provide definition and presumptions on when a person is treated as having separated from service for the purposes of Code section 409A. These rules have particular importance to a person who may terminate his or her role as an employee but continue providing certain services in the capacity as an independent contractor or consultant or work for a related company. These rules also prevent a plan from using salary continuation payments (without any services) to cause the person to be treated as still employed for Code section 409A purposes. A presumption occurs that a person has separated from service where the level of services decline to no more than 20% of

average services performed over the preceding 36 months and a person is presumed not to have separated from service if the level of service continues at 50% or more of average services performed during that prior 36 month period. There is no presumption under the Final Regulations between 20 and 50%. The Final Regulations note that in an asset acquisition, the buyer and seller can specify in the agreement whether a person will be treated as being in the same position and having not separated from service for Code section 409A purposes.

Change in Control Distribution Event

As in the proposed regulations, the Final Regulations have substantial definitions of what constitutes change in control, effective change in control, and transfer of substantially all assets. With respect to effective change in control, the threshold percentage has now been reduced to 30%.

Specified Date/Fixed Schedule Distribution Event

Substantial rules apply with respect to the specified date/fixed schedule distribution event. The Final Regulations provide that reimbursements and in kind benefits will be treated as meeting this distribution event if the reimbursement right or in-kind benefit is objectively defined, the period in which the reimbursement or benefit is available is set forth, the amount eligible for reimbursement during a taxable year does not affect the amount eligible for reimbursement in another taxable year (except medical reimbursements may be subjected to a cap), the reimbursement right or in-kind benefit right is not subject to liquidation or exchange for another benefit and the reimbursement of the eligible expense is made on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred. With respect to tax indemnities or tax gross ups, the specified date distribution event is treated as met if the plan requires the indemnity or gross up payment to be made by the end of the service provider's taxable year following the year the service provider remits the tax to the applicable taxing authority or the year after the conclusion of the audit or tax controversy.

Deferral Election Requirements

Under Code section 409A, an election with respect to the time and/or form of payment generally must be made by the close of the service provider's taxable year preceding the year in which the services will be performed for which the compensation is payable. New participants must make the deferral election within 30 days of becoming eligible to participate in the plan, and the initial election with respect to a payment subject to a substantial risk of forfeiture with respect to at least 12 months of services may be made within 30 days after obtaining the legal right to such compensation provided that such election is made at least 12 months before the earliest date the forfeiture

condition could lapse. With respect to performance based pay, such as certain bonus situations, the election must be made at least 6 months before the end of the performance period (a period of at least 12 consecutive months), provided the service provider performs services continually from the later of the beginning of the performance period or the date the performance period criteria is specified through the date the election is made and the election is made before the compensation amount can be readily ascertainable. Special rules apply to commissions and situations in which the service provider's compensation is determined by reference to the service recipient's compensation and where compensation is based on the service recipient's fiscal year instead of the service provider's taxable year. The Final Regulations specify that an initial election with respect to voluntary or involuntary separation payment may be made at anytime before the legally binding right to the payment arises. Thus, employees who previously have not had any right to separation pay could negotiate separation pay arrangements and specify when the payments are to be paid following separation from services at any time prior to separating from service.

Nonacceleration Requirements

Code section 409A generally forbids or restricts the acceleration of payments and changes in elections once they are required to have been made. Generally, the time and form of payment may only be changed if the election cannot take effect for 12 months, if the election is not with respect to death, disability, or unforeseeable emergency, the payment date must be deferred for an additional 5 years, and with respect to a specified payment event, the election must be made not less than 12 months prior to the date the payment was scheduled to be made. For the purposes of these rules, an annuity is treated as a single payment and thus a change in election would need to comply with these election change provisions before the first annuity payment is made. A series of installment payments can be designated to constitute separate payments or one payment for Code section 409A purposes. The Final Regulations address situations in which plans can permit acceleration with respect to domestic relations orders, compliance with conflict of interest and ethic laws, unforeseeable emergencies, payment of

employment taxes, payment of Code section 409A liabilities, and plan terminations by the service recipient. The Final Regulations also address changes to payments resulting from NDC plans that are linked to qualified plans, changes of beneficiaries and changes in annuity contracts.

6 Month Rule for Specified Employees of Publicly Traded Companies

Code section 409A contains a special rule that applies to specified individuals of publicly traded companies, precluding the payment of separation amounts within the six month period following the date of separation (except acceleration can occur upon death). The specified individuals are generally 5% owners of the company, a 1% owner whose compensation exceeds a certain amount, and the top paid 50 officers of the company (or if lesser, the greater of 3 or 10% of all the employees). The Final Regulations contain rules permitting the employer flexibility in selecting the dates specified employees are identified and how specified employees are determined as the result of various corporate actions such as mergers of publicly traded companies or going public transactions. With respect to such specified employees, service recipients may wish to consider separation pay plans that are excluded from the deferral definition under the Final Regulations as discussed above.

Further Assistance

The foregoing is attended only for general information purposes. If you have questions regarding Code section 409A, the Final Regulations, or other tax and compensation related questions, feel free to contact the Goldberg Kohn attorneys with whom you work, or Goldberg Kohn attorneys Denise Caplan 312.201.3901, Gerald Jenkins 312.201.3902, Michael Karpeles 312.201.3910, Stephen Legatzke 312.201.3911, or David Morrison 312.201.3972.

THIS ALERT IS NOT INTENDED TO BE, AND IS NOT, LEGAL OR TAX ADVICE. PLEASE CONSULT YOUR OWN TAX ADVISOR WITH RESPECT TO THE CONSEQUENCES OF SECTION 409A OF THE INTERNAL REVENUE CODE AND THE TREASURY REGULATIONS PROMULGATED THEREUNDER TO YOU IN LIGHT OF YOUR OWN PARTICULAR CIRCUMSTANCES. IN ACCORDANCE WITH TREASURY CIRCULAR 230, YOU ARE HEREBY ADVISED THAT THE DISCUSSION CONTAINED HEREIN IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, BY YOU OR ANY PERSON FOR THE PURPOSES OF AVOIDING PENALTIES FOR FEDERAL TAX PURPOSES OR THE PROMOTING, MARKETING, OR RECOMMENDING TO ANOTHER PARTY ANY PLAN OR ARRANGEMENT.