Shipman & Goodwin LLP

Employee Benefits Update

October 30, 2007

SECTION 409A DEFERRED COMPENSATION: GOOD FAITH COMPLIANCE, TRANSITION OPPORTUNITIES AND PREPARATION FOR FULL COMPLIANCE

Final regulations promulgated under Section 409A of the Internal Revenue Code require employers to review, and possibly amend, their various employment agreements, bonus plans and other compensation arrangements. Failure to bring these arrangements into compliance with 409A could result in the imposition of significant penalties, as described below.

I. Extended Transition Period

"Good faith" compliance with Section 409A and regulatory guidance has been required since 2005. However, the IRS recently extended the existing transition period for an additional year, delaying the effective date of the final regulations to January 1, 2009.[1] This means there's time to make any changes needed to bring arrangements into full compliance with the final regulations. There's even some flexibility during this period for employees to change payout elections before more stringent election rules apply. Key points during the transition include:

- For the remainder of 2007 and 2008, all arrangements must be operated in good faith compliance with a reasonable interpretation of Section 409A, taking into account transition rules announced in 2005. (The final regulations may be relied upon but are not binding; the proposed regulations cannot be relied upon after December 31, 2007.)
- Elections as to time and form of payment can be changed during 2007, but not to defer amounts otherwise payable during 2007 or to accelerate into 2007 amounts that otherwise would be payable in a future year. Similarly, elections can be changed during 2008, but not to defer

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amounts otherwise payable during 2008 or to accelerate into 2008 amounts that otherwise would be payable in a future year. Employers may, but are not required to, allow employees the opportunity to make such elections.

• Written documents must be amended by December 31, 2008.

The web of detailed rules in the final regulations is exceedingly complex. The remainder of this article describes the basic requirements of 409A and provides a framework to determine whether an arrangement may be subject to 409A.

II. Basic Requirements of 409A

The genesis of 409A was the perceived abuse of lucrative deferred compensation arrangements with executives and directors. With the enactment of 409A, however, Congress cast a much wider net. Due to its scope and breadth, 409A carries potential implications for any arrangement under which a promise is made in one tax year to pay an amount in a future tax year (even if the promise is subject to vesting). It applies regardless of whether an arrangement is elective or non-elective, broad-based or specific to one individual, the type of compensation provided or the type of service provider (e.g., employee, independent contractor, director).

If an arrangement involves a promise made in one year to pay compensation in a future year and it cannot be made to fit within any exception to 409A (some of which are described in III. below), the arrangement must be stated in writing and must comply with the deferral rules and distribution rules described below.

Deferral Rules. If the arrangement permits the employee to defer amounts from his or her own pay, the employee must make the election to defer before the first day of the year in which the compensation will be earned. Some exceptions are available for newly eligible participants and certain types of performance-based compensation and commissions, but they are relatively narrow and rigid.

Distribution Rules.

General rule. Every deferred compensation arrangement must specify the time and form of payment, or require the employee to elect the time and form of payment, before the first day of the year in which the deferred compensation is earned. During the 2007 and 2008 extended transition period, the time and form of payment may be elected or changed with respect to

compensation already earned, provided the change does not affect compensation otherwise payable that year, as described above. In addition, arrangements that link the time and form of distribution to an election made under a qualified plan may continue to do so during this extended transition period.

Permissible payment events. The specified time of payment must be no earlier than one of the following events: separation from service, disability, death, a specified and objectively determinable date (or schedule of dates), a change in control of the employer or an unforeseeable emergency. ***Practical tip:*** Several of these payment events are defined in detail in the final regulations which apply beginning January 1, 2009; in order to make payment upon occurrence of the event, the arrangement must incorporate a 409A-compliant definition. For example, the final regulations contain detailed rules to determine whether a separation from service has occurred in the context of a reduced work schedule (such as a consulting arrangement), an unpaid leave of absence and certain corporate transactions.

Change in time or form of payment. These rules apply after the transition period ends December 31, 2008. (During the transition period, payment elections may be changed as described above.) A payment generally can never be accelerated. It may be further deferred, and the form of payment may be changed, but only if: (1) the change is made at least 12 months before the scheduled payment date and (2) payment is delayed for at least five additional years. These rules apply regardless of whether the employee or the employer is seeking to change the time or form of payment. As explained above, changes to time and form of payment elections made during the transition period need not comply with these rules.

Six-month delay in payment. For public companies, payments to “specified employees” (generally, officers earning at least $145,000) upon separation from service must be delayed six months following the employee’s separation. Complicated rules determine who is a specified employee and how specified employees are determined following certain corporate transactions such as an IPO or the acquisition of a private employer by a public employer. This rule applies even during the transition period (except where distribution is linked to a qualified plan election as noted above). ***Practical tip:*** Since this provision must be included in the plan document if it applies, a private employer going public might consider amending the document in advance (conditionally) to avoid any period of documentary noncompliance.

Penalties for Violation. Violation of Section 409A results in extremely onerous, confiscatory tax consequences for affected employees: immediate taxation, plus interest from the date first deferred, plus an additional 20% penalty tax. Although the legal penalty falls on the employee, an employer responsible for compensation design and administration will need to understand these rules in order to establish a compliant structure for its employees (and to comply with 409A tax reporting obligations, not yet fully effective but which may eventually carry their own penalties on the employer responsible for tax reporting and withholding).

Special note for tax-exempt employers: In addition to the new 409A rules, tax-exempt employers with non-qualified arrangements still must comply with the 457(f) rules, under which benefits are taxed immediately upon vesting. For example, if a vesting date is delayed for 457(f) purposes (to delay taxation under the so-called "rolling risk of forfeiture" approach), 409A requires the resulting delay in payment date to satisfy the rules on changing the time of payment (i.e., the change must be made at least 12 months in advance and must defer payment for at least five additional years). In July, the IRS issued Notice 2007-62, indicating its intent to issue future guidance to make the 457(f) rules similar to the 409A rules; this may completely foreclose use of rolling risks of forfeiture.

III. 409A Action Plan

Identify All Arrangements Potentially Subject to 409A

The first step to compliance is identifying all arrangements potentially subject to 409A. You should consult with appropriate colleagues in your legal, human resources and finance departments and review all compensation policies, plans and arrangements, including individual employment agreements, change-in-control agreements, severance plans, bonus and incentive plans, plans established to provide additional pension benefits to highly paid employees over IRS limits and equity compensation plans.

Determine Applicable Exceptions to 409A

The next step is to determine whether the arrangements fit within, or could be modified (during the transition period) to fit within, an exception to 409A. Tax-favored plans (such as 401(k), 403(b) and 457(b) plans, profit-sharing plans and qualified pension plans) are not subject to 409A. The Code and the final regulations provide several other exceptions. Three of the most useful exceptions are:

Short-term deferral exception – may be useful for: bonus plans, lump-sum severance payments and many other forms of compensation. Many broad-based bonus plans, although they provide for payment of compensation in the following calendar year, will be excepted from 409A under the "short-term deferral rule." This rule provides an exception for amounts paid within 2½ months after the tax year in which vesting occurs (i.e., March 15 if using a calendar year). Either the employer's tax year or the employee's tax year can be used. ***Practical tip:*** By stating in the plan document that payment will be made by March 15, the short-term deferral exception will be available even if administrative delay pushes the actual payment date to later in the year. This exception may also be useful for severance payments that exceed the dollar limit in the severance exception (described below), if they are payable only in the event of involuntary termination and all payments are made within 2½ months after the tax year in which involuntary termination occurs.

Severance pay exception – for involuntary terminations not paid in a lump sum. Section 409A provides a limited exception for severance and separation payments to the extent that (1) payment is made only upon an involuntary termination (or pursuant to a "window program" as defined in the regulations), (2) the amount does not exceed the lesser of two times compensation or $450,000 (the 2007 limit, subject to increase annually), and (3) all payments are completed no later than the end of the second year following the year of termination. ***Practical tip:*** An employee's resignation for "good reason" will be considered an involuntary termination only if it meets certain objective criteria in the regulations; this may necessitate review and amendment of the definition of "good reason" in relevant documents if it is intended that a good reason termination be treated as involuntary.

Stock option exception – or non-discounted stock options and stock appreciation rights. The final regulations provide a broad exception from 409A for stock options and stock appreciation rights (SARs) that satisfy certain requirements: (1) the exercise price is no less than the fair market value of the stock on the date of grant, (2) the stock is stock of the "service recipient" (generally the employer or a parent employer, but not a subsidiary), and (3) no further deferral is permitted. Because virtually all stock options and SARs provide for exercise dates that can be elected in the future, if they fail to satisfy this exception they almost certainly will not comply with 409A. (Note that this exception does not apply to restricted stock units, which may satisfy the short-term deferral exception discussed above if they provide for payment upon vesting and are not permitted to be further deferred.)

Watch out for: valuation of stock not traded on an established market. Such value must be determined in accordance with the regulations, which offer a general "reasonableness" approach (with a list of factors to be taken into account), as well as several methods that carry a presumption of reasonableness. An annual appraisal by an independent appraiser is presumed reasonable, but is not always required.

Also watch out for: modifications and extensions. Certain changes to an option or SAR's original terms will cause it to fail the exception. Generally, an impermissible modification includes any change that reduces the exercise price. Certain extensions are permitted, including: (1) the extension of the exercise period up to the earlier of the end of the original term or the 10th anniversary of the grant date, and (2) the extension of the exercise period when an option or SAR is underwater. These rules should be reviewed in detail when contemplating any modification, for example in connection with a corporate transaction or as a special retention or severance arrangement for an individual.

Comply with 409A

If you determine that you have an arrangement subject to 409A, it must comply with all of 409A's rules, the most significant of which are described in the "Basic Requirements of 409A" above. Now is the time to take advantage of the extended transition period to ensure you have identified each arrangement subject to 409A and are implementing appropriate steps to achieve timely compliance. The rules are much more detailed and complex than outlined above and you should consult with counsel regarding the compliance alternatives that may be available in particular circumstances.

Shipman & Goodwin's Employee Benefits and Executive Compensation attorneys are experienced in assisting employers throughout the 409A action plan – reviewing existing deferred compensation arrangements, analyzing design alternatives and drafting or amending plan documents.

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[1] IRS Notice 2007-86 (October 22, 2007), superseding the partial extension issued in September, 2007 under Notice 2007-78.

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Shipman & Goodwin's **Employee Benefits and Executive Compensation** attorneys are experienced in assisting employers throughout the 409A action plan — reviewing existing deferred compensation arrangements, analyzing design alternatives and drafting or amending plan documents.

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