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SECTION 409A FINAL REGULATIONS: WHAT YOU NEED TO KNOW AND DO (AND BY WHEN)

SESSION 1: OVERVIEW OF 409A AND FINAL REGULATIONS

May 8, 2007

Introduction: Susan P. Serota

Presenters: Howard L. Clemons, Peter J. Hunt and Daniel N. Rosenberg

- ▶ Review of Basic Concepts
- ▶ Transition Relief Still in Effect
- ▶ Review of Final Regulations
 - Plan Aggregation Rules
 - Deferred Compensation Defined – Exemptions and Short-Term Deferrals
 - Guidance on elections and distributions
 - “Specified Employees” of Publicly Traded Companies
 - “Linked Plans” (nonqualified plans with benefits linked to qualified plan benefits)

- ▶ Action Items and Deadlines
- ▶ Topics Covered in Subsequent Teleconferences
 - Equity Compensation and Merger and Acquisition Implications
 - Employment Agreements and Severance
 - Multinational Employers

Basic Concepts



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- ▶ Grandfathering—deferred amounts earned and vested by December 31, 2004, and not materially modified after October 3, 2004
- ▶ Penalties for noncompliance
 - Regular income tax
 - 20% additional income tax
 - Additional interest—underpayment rate + 1%
- ▶ Plan aggregation rules



Basic Concepts: Excluded Plans

- ▶ “Deferred compensation”—legally binding right to compensation payable in later year
- ▶ Excluded plans
 - “Qualified employer plans,” eligible deferred compensation plans under IRC 457(b), bona fide vacation, sick leave, compensatory time, disability pay or death benefits, Section 83 property transfers (including promise to transfer property that will not be substantially vested on transfer)
- ▶ Short-term deferrals (2 ½ month rule)

Basic Concepts: Initial Deferral Elections



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- ▶ Deferral election in calendar year prior to year services are performed
- ▶ Later deferral election for “performance-based” compensation – 6 months prior to end of performance period
- ▶ Special rule for first year of eligibility for a “plan” (per the plan aggregation rules)– election during first 30 days

Basic Concepts: Distribution Events



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- ▶ **Distribution only on specified dates or events**
 - Separation from Service (6 month delay for public company “specified employees”)
 - Death or Disability
 - Set time or fixed schedule
 - Change in Control Event
 - Unforeseeable Emergency

Basic Concepts: Distribution Elections



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- ▶ No acceleration
- ▶ Distribution elections at time of initial deferral
- ▶ Changes in distribution elections
 - 12 month/ 5 year rules
- ▶ “Linked” plan distributions—transition required

Basic Concepts: Funding



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- ▶ Offshore Trusts—participants may be taxed at vesting
- ▶ Funding on change in employer's financial health—taxable transfer
- ▶ Defined benefit pension plan sponsors funding deferred compensation during a “restricted period” – taxable transfer
 - Pension plan in “at risk” status
 - Pension plan sponsor in bankruptcy
 - Termination of an “insufficient” pension plan

Final Regulations



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- ▶ January 1, 2008 effective date
- ▶ Transition relief through December 31, 2007
- ▶ Basic framework of proposed regulations maintained
- ▶ New plan aggregation rules, other interpretive guidance
- ▶ Delayed effective date for collectively bargained plans – later of:
 - Expiration of CBA in effect in October 3, 2004
 - December 31, 2009

Issues Not Covered in Final Regulations



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- ▶ Calculation of income inclusion
- ▶ Reporting and withholding
- ▶ Funding – offshore trusts, change in financial health, “at risk” pension plans
- ▶ Partnerships

Transition Relief



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- ▶ Transition relief period ends December 31, 2007
- ▶ Good faith compliance—can rely on Notice 2005-1, Proposed Regulations, Final Regulations, other published guidance
- ▶ Can change time and form of payment elections through December 31, 2007, except:
 - Cannot affect amounts scheduled for payment in 2007
 - Cannot cause payment to be made in 2007
- ▶ “Linked” plan payment elections can continue through 2007

Written Plan Requirements

- ▶ Must ensure compliance effective January 1, 2008
- ▶ Do not need retroactive amendments
- ▶ One or more documents must include:
 - Payment amount or formula
 - Payment schedule or trigger events
 - Conditions of initial or subsequent deferral election
 - 6-month delay procedure (public companies)
- ▶ Savings clause not enough
- ▶ Plan aggregation rules do not apply to written plan violations

Plan Aggregation Rules: Final Regulations

- ▶ For purposes of determining whether 409A is violated, and identifying the deferred compensation to which the additional taxes and penalties apply, plans of the same type maintained by the same employer and covering the same service provider are aggregated
 - Account balance plans with deferral at election of service provider (elective deferral defined contribution type plans)
 - Nonelective account balance type plans
 - Nonaccount balance type plans (defined benefit type plans)

Plan Aggregation Rules: Final Regulations



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- Separation pay plans payable solely on involuntary separation or participation in a “window benefit” program
- Rights to in-kind reimbursements (e.g., membership fees, aircraft or vehicle usage) but only if not a “substantial portion” of overall compensation
- Deferrals subject to taxation under split-dollar life insurance rules
- Deferrals to the extent treated as modified foreign income
- Deferrals with respect to stock rights
- All deferred compensation not included in another category

Deferred Compensation: Exemptions



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- ▶ Agreement to transfer unvested property
- ▶ Choice between cash and restricted stock or options
- ▶ Indemnification and liability insurance
- ▶ Legal settlements, court awards, attorney fee awards
- ▶ Split-dollar “loan” arrangements – where no commitment to forgive loan
 - Notice 2007-34
- ▶ Benefits excludable from income (e.g., health insurance, death benefits)
- ▶ Education assistance

Deferred Compensation: Exemptions

Separation Pay Exemptions:

- ▶ Notice 2005-1 transition relief for certain broad-based severance plans
- ▶ Collectively bargained arrangements
- ▶ Exemption for reimbursements for limited period of time—paid by December 31st of 2nd calendar year following year of separation
- ▶ Business expense reimbursements, outplacement, moving expenses, medical expenses
- ▶ Exemption for de minimis payments (\$15,500 in aggregate for 2007)

Deferred Compensation: Exemptions

Separation Pay Exemptions:

- ▶ Payments on involuntary separation from service, or participation in window program (window not more than 1 year)
 - Involuntary separation can include “good reason” termination—safe harbors provided
 - Payments cannot exceed 2 times lesser of annualized compensation for prior calendar year or compensation limit for qualified plans (\$225,000 for 2007)
 - Payments made no later than December 31st of 2nd calendar year following calendar year of separation

Short-Term Deferrals (2 ½ month rule)



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- ▶ As in Proposed Regulations, payment by end of 2 ½ month period after year of vesting does not have to be mandated by plan document—but plan provision still advisable
- ▶ Final regulations clarify that payment that may be made after 2 ½ month period is not short-term deferral even if paid within 2 ½ month period (e.g., payment due on separation from service)
- ▶ Payment includes amount actually or constructively received, including amounts taxable under IRC 457(f) (ineligible plan of tax-exempt organization)
- ▶ If any part of a payment treated as a single payment is deferred beyond the short-term period, entire payment is deferred compensation
- ▶ No loss of short-term deferral status if payment delayed due to unforeseeable administrative impracticability, the payment would jeopardize service recipient's ability to continue as going concern (proposed regulations used insolvency standard) or a failure to be deductible under IRC 162(m) that a reasonable person would not have anticipated

Initial Deferral Elections: Performance-Based Compensation



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- ▶ Performance period of at least 12 months
- ▶ “Preestablished” organizational or individual performance criteria—no later than 90 days after start of performance period
 - Can include “subjective” performance criteria
- ▶ Outcome must be substantially uncertain at time performance goals set
- ▶ Continuous employment from later of:
 - Beginning of performance period, or
 - Date performance criteria are established

Initial Deferral Elections: Performance-Based Compensation



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- ▶ Deferral election must be made before amounts are “readily ascertainable”
 - Can bifurcate amounts
- ▶ Performance-based election rules can apply to portion of award
- ▶ Automatic payment triggers permitted
 - Death, disability, change in control
 - If event occurs prior to election, lose performance-based exception

Initial Deferral Elections: Fiscal Year Compensation



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- ▶ Can elect deferral before fiscal year in which perform any services, but must be for bonus (not salary) based on fiscal year and not otherwise payable during fiscal year

Initial Deferral Elections: Short-Term Deferrals

- ▶ If wish to defer amounts that would be exempt under 2 ½ month rule
 - Performance-based-- can make deferral election up to 6 months prior to end of performance period
 - Not performance-based-- can treat as “second election”
 - Deferral election must be made at least 12 months in advance of date substantial risk of forfeiture lapses
 - Must provide additional deferral of at least 5 years (but may provide for payment on change in control)

Initial Deferral Elections: Forfeitable Compensation



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- ▶ If right to payment in future year is contingent on continued service for at least 12 months, may elect deferral within 30 days after grant
 - Election only applicable to amounts that will not vest for at least 12 months after election
 - Earlier vesting permitted for death, disability, change in control

Initial Deferral Elections: First Year of Eligibility

- ▶ **Plan aggregation rules apply**
 - Can treat elective and non-elective portions of plan separately
- ▶ **Election applies only to compensation for services after the election**
 - May have to prorate annual bonus
- ▶ **Rehired or transferred participants**
- ▶ **Excess benefit plans – delayed election permitted**

Initial Deferral Elections: Irrevocable



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- ▶ Evergreen elections permitted if they become irrevocable by the deadline for making initial deferral elections for each later year
- ▶ Outstanding elections may be terminated upon an unforeseeable emergency or if necessary to obtain hardship distribution under 401(k) plan

Initial Deferral Elections: Special Situations



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- ▶ **Commissions**
 - Sales and investment commissions
- ▶ **Annualizing part-year compensation**
 - School employees
- ▶ **USERRA**

Initial Deferral Elections: Separation Pay

- ▶ **Later deferral elections permitted for terminations and window programs**
 - Voluntary or Involuntary termination—If separation pay subject to bona fide, arms' length negotiations (and no pre-existing right), can make deferral election any time before legally binding right to income arises
 - Window program—can make election at any time before election to participate in window program becomes irrevocable
- ▶ **Applies also to time and form of payment elections**

Time and Form of Payment: General

- ▶ Must be elected by the deadline for making deferral elections
- ▶ If employee does not have the right to make an election regarding time and form of distribution, the plan must designate the time and form by the later of the date the employee first has a legally binding right to the compensation or the date that the employee would be required to make such an election, if permitted under the plan

Time and Form of Payment: When Does Separation From Service Occur?



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- ▶ Separation is permissible distribution event (6 month delay for specified employees of public companies)
- ▶ Controlled group rules apply in determining whether separation has occurred; plans may specify particular ownership percentage levels, within limits
- ▶ No separation if military leave, sick leave or other bona fide leave of absence (6 month maximum unless reemployment protected by statute or contract)
- ▶ Disability leave may continue for up to 29 months before separation is deemed to occur
- ▶ “Same desk” rule may be used in asset purchase agreements so that separation will not occur

Time and Form of Payment: Separation From Service- Continued Relationship



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- ▶ General rule: Separation from service occurs if, based on facts and circumstances, parties reasonably anticipate that no further services will be performed or that level of services will decrease to 20% or less of average service level (“ASL”), determined over preceding 3-year period (as employee or independent contractor)
- ▶ Rebuttable presumption that separation occurred if level of services decreases to 20% or less of ASL
- ▶ Rebuttable presumption that separation did not occur if level of services continues at 50% or more of ASL
- ▶ Plan may define separation from services as specific anticipated reduction of level of services that is greater than 20% and less than 50% of ASL

Time and Form of Payment: 6-Month Rule for “Specified Employees”



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- ▶ Payment cannot be made during first 6 months after separation from service or, if earlier, the date of death
- ▶ Plan or agreement must specify that the 6-month delay will be implemented by a delay of all payments or a delay of payments for first 6 months only, with catch-up after 6 months

Time and Form of Payment: Who is a “Specified Employee”?



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- ▶ Publicly traded company is traded on established securities market, including foreign exchange or U.S. exchange as ADRs (applies to all controlled group members if one member is publicly traded)
- ▶ Specified employees are employees who either have significant stock ownership or are officers
- ▶ “Officers” must have annual compensation of at least \$145,000 (in 2007, increases with cost of living) and are ranked by compensation to determine who is specified employee
- ▶ Officers limited to lesser of (1) 50 employees or (2) greater of 3 employees or 10% of workforce
- ▶ Identification of specified employees based on 12-month period ending on “identification date”, includes employees who meet requirements at any time during period and is effective as of a subsequent “effective date”

Time and Form of Payment: Employer Flexibility In Identifying Specified Employees



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- ▶ Definition of compensation- Any available definition under IRC Section 415 is acceptable
- ▶ Identification date- Unless otherwise designated, December 31st
- ▶ Effective date- First day of fourth month following identification date, or earlier designated date following identification date
- ▶ Alternative methods of compliance- All employees are subject to 6 month rule or include up to 200 employees as specified employees

Time and Form of Payment: Employer Flexibility In Identifying Specified Employees



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- ▶ Merger or acquisition of 2 or more public companies— use acquiring company's identification date and effective date and combine lists until next effective date
 - Other reasonable methods permitted, but must adopt within 90 days of transaction
- ▶ Merger or acquisition of nonpublic company- use identification date and effective date that would have been used by public company; employees of private company are not specified employees for period between transaction and next effective date
- ▶ Nonresident alien employees— compensation included in determining specified employees (but employer can elect to exclude)
- ▶ Same elections must apply to all plans in controlled group

Time and Form of Payment: Designated Payment Dates



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- ▶ If date of distribution is specified, distribution is treated as made on the specified date if made (i) no earlier than 30 days before the specified date, or (ii) on a subsequent date during the same calendar year, or (iii), if later, within 2-1/2 months after the specified date
- ▶ Designation of year or period of time during year-- specified date is treated as first day of year or period of time
- ▶ “As soon as administratively feasible” distribution permitted if payment is made within one taxable year or 90 days after payment event and no election by employee is permitted

Time and Form of Payment: Multiple Payment Events

- ▶ Different payment times and forms may apply to different payment events
- ▶ Payment may be on later or earlier of two permitted events
- ▶ In general, plan may provide for a different form of payment if an event occurs on or before a specified date (limited to one such date)
- ▶ Also, a different form and time of payment may be elected for separations from service under each of the following conditions: (i) separation during a limited period of time not to exceed two years following a change of control event; (ii) separation before or after a specified date (or before or after a combination of a specified date and a period of service); and (iii) separation not described in (i) or (ii)

Time and Form of Payment: Subsequent Changes

- ▶ Subsequent election may not take effect for at least 12 months after it is made
- ▶ Except for election related to payment on account of death, disability or unforeseeable emergency, payment must be deferred for at least five years from the date the payment would otherwise have been made
- ▶ Life annuity treated as single payment
- ▶ Installment payments treated as single payment unless election is made to treat each installment as single payment
- ▶ No restriction on changes in actuarially equivalent forms of life annuities (certain features of an annuity are disregarded for the purpose of determining whether a payment form is a life annuity)

Time and Form of Payment: Delays in Payment



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- ▶ Employer reasonably anticipates loss of deduction under IRC Section 162(m), subject to certain conditions regarding later payment
- ▶ Violation of securities or other laws
- ▶ Disputed payments or refusal to pay
- ▶ If employer's ability to continue as going concern is jeopardized
- ▶ Based on prescribed objective nondiscretionary business performance formula

Time and Form of Payment: Permitted “Accelerations”

► Plan terminations

- Change in control event: all aggregated plans are terminated during period beginning 30 days before and ending 12 months after change in control; distribution occurs within 12 months of termination
- Bankruptcy or liquidation: termination within 12 months; distribution occurs within same calendar year (or first calendar year practicable)
- Termination of all aggregated plans: distribution during 2nd 12-month period after termination (payouts during 1st 12-month period permitted in accordance with plan documents); no new plan that would be aggregated with terminated plan is established for 3 years

Time and Form of Payment: Permitted “Accelerations”



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- ▶ Domestic Relations Orders
- ▶ Limited cash-out of employee's entire interest (in all aggregated plans) if amount is not greater than permitted 401(k) deferral amount
- ▶ Withholding taxes or Section 409A penalties

“Linked” Plans



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- ▶ Excess or offset plans—deferral election rules do not apply to increases or decreases in qualified plan benefits that affect nonqualified plan benefits
 - Changes in qualified plan tax limits
 - Amendments to qualified plan
 - Election (or failure to elect) ancillary or subsidized benefits under qualified plan

“Linked” Plans



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▶ Linked 401(k) plans

- Changes in 401(k) plan contribution elections that affect nonqualified plan benefits (including both deferrals and matching contributions) are permitted
- Additional nonqualified deferrals for calendar year cannot exceed Section 402(g) deferral limit (\$15,500 for 2007)
- Additional nonqualified matching contributions for calendar year cannot exceed 100% of match under qualified plan formula (without Code limits)
- Transfer of amounts from nonqualified 401(k) “wrap” plan to qualified 401(k) plan is permitted

“Linked” Plans: Distribution Elections



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- ▶ Transition relief extended to December 31, 2007
- ▶ Will need elections (or default options) under nonqualified plans that comply with 409A
- ▶ Nonelective excess plans
 - Can make distribution election during first 30 days following end of first calendar year in which accrue benefit

Summary of Action Items & Deadlines

- ▶ **December 31, 2007 – Deadline for documentary compliance for periods on and after January 1, 2008 (amendments are NOT required for periods prior to January 1, 2008; ability to demonstrate operational compliance is required) – Most transition relief ends**
- ▶ **January 1, 2008 – Final regulations effective**
- ▶ **Action Items**
 - Inventory compensation arrangements potentially providing deferred compensation (again)
 - Review stock option and stock appreciation rights for potential coverage by 409A (and pricing procedures for avoiding coverage)

Summary of Action Items & Deadlines



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- Procedures for reimbursements and in-kind benefits should be reviewed to avoid violating the requirement that deferred compensation be provided on a fixed schedule of payments
- Companies with publicly traded stock need to review method to be used for identifying specified employees
- Companies with publicly traded stock should consider changes that will lessen the impact of the six month delay rule
- Election and payment procedures under all deferred compensation plans need to be reviewed

Future Teleconferences on 409A Final Regulations



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- ▶ **Equity Compensation and Merger & Acquisition Implications**
Tuesday, May 15, 2007
10:00am Pacific / 1:00pm Eastern
- ▶ **Employment Agreements and Severance**
Tuesday, May 22, 2007
10:00am Pacific / 1:00pm Eastern
- ▶ **Multinational Employers**
Tuesday, June 5, 2007
10:00am Pacific / 1:00pm Eastern

For further information or to register, contact
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