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ERISA/TAX CLIENT ALERT

KEY CHANGES MADE BY THE FINAL 409A REGULATIONS

INTRODUCTION

The IRS has issued long-awaited final regulations under Code §409A, relating to non-qualified deferred compensation ("NQDC") plans. The rules are effective January 1, 2008 and taxpayers may rely on them for all periods. Employers have until December 31, 2007 to amend NQDC plans to comply with the final regulations. The IRS has made clear that this deadline will not be extended. The final regulations also make clear that adding a §409A "savings clause" to a plan will not prevent a non-compliant plan from violating §409A. The final rules require that the written plan documents specify the amount being deferred (or a formula for determining this amount), the time and form of payment (including the six-month delay for payments to "key employees" of public companies on account of separation from service), and the conditions under which initial or subsequent deferral elections may be made. These requirements may be set forth in one or more documents, e.g., a deferral election form and a plan document. The following discussion examines some of the key changes that the final regulations make to the proposed regulations issued in 2005.

DEFINITION OF NQDC PLAN

The regulations provide that a NQDC plan does not include a qualified retirement plan, a bona fide sick leave or vacation plan, a disability plan, a death benefit plan, or certain medical reimbursement plans. The exemption, however, does not apply to medical reimbursements that are taxable to the employee.

Under the final rules, §409A generally does not apply to an amount deferred under an arrangement between an employer and an independent contractor if, during the contractor's taxable year in which the contractor earns a legally binding right to the deferred amount, the contractor is actively engaged in the trade or business of providing services other than as an employee or as a corporate director and provides significant services to two or more employers to which the contractor is not related and that are not related to one another. To provide substantial services, no more than 70% of the contractor's total revenues can come from a single employer or employer group. A contractor that has met the 70% test for each of the last three years automatically passes the test in the current year unless the contractor knows or has reason to know it will fail the test in the current year. If, at the time the claim to the payment arose, the arrangement was not subject to §409A because the contractor met the 70% test, the amount deferred during that taxable year (and earnings thereon) will not become subject to §409A in a later year if the individual subsequently becomes an employee, independent contractor, or other type of employee subject to §409A.

DEFINITION OF DEFERRED COMPENSATION

The regulations define deferral of compensation as a legally binding right to a payment of compensation in a future taxable year. Such a right includes a contractual right enforceable under applicable law governing the plan. Under the regulations, a NQDC plan provides for deferred compensation if, under its terms and the surrounding facts and circumstances, an employee has a legally binding right during a taxable year to compensation that is or may be payable to (or on behalf of) the employee in a later year. An amount generally is payable when the employee gains a right to currently receive

a transfer of cash or property. A taxable transfer of an annuity contract is a payment under §409A.

The definition does not require that the amount not be actually or constructively received and included as income during the taxable year. For example, if an employee elects irrevocably to defer compensation to a future year, the compensation is deferred compensation regardless of whether the employer actually pays it in the year in which the employee performs the services. Any early payment of the deferred compensation (or right to receive such an early payment) generally is an acceleration of payment in violation of §409A.

A plan is treated as providing for a payment to be made in a later year whether the plan so provides (including through an employee election) or the deferral condition is inherent in the plan terms. Where the parties have agreed that a payment will be made upon an event that could occur after the year in which the legally binding right to the payment arises, the plan generally will constitute deferred compensation unless otherwise excluded under an exception, such as the short-term deferral rule.

For example, if an employee is entitled to a payment upon separation from service, the payment will be deferred compensation regardless of whether the employee separates and receives the payment in the year of the grant, because the payment is conditioned upon an event that may occur after the year in which the legally binding right to the payment arises. Similarly, if an arrangement such as a stock option or stock appreciation right ("SAR") not otherwise exempt from §409A provides a right to a payment for a term of years where the payment could be received during the short-term deferral period or a later period but is not otherwise includible in income until paid, this would constitute deferred compensation even though the employee could receive the payment during the short-term deferral period by exercising the stock right. However, where a plan does not specify a payment date, payment event or term of years, or specifies a date or event certain to occur during the year in which the services are performed, the plan generally does not provide for deferred compensation if the employee actually or constructively receives the payment before the end of the short-term deferral period.

A legally binding right earned in one year to a payment in a later year in connection with a non-compete agreement generally constitutes deferred compensation.

SHORT-TERM DEFERRALS

The final rules generally adopt the short-term deferral rule in the proposed regulations. Under that rule, a deferral of compensation does not occur if the arrangement does not provide for a deferred payment and the payment is made no later than 2½ months after the later of the end of the employee's taxable year or the end of the employer's taxable year in which occurs the later of the time the legally binding right to the payment arises or the time such right first becomes nonforfeitable. An arrangement provides for a deferred payment if the payment that will be made or completed after a date or event that will or may occur after the end of the 2½-month period, either because of the employee's or employer's election or a deferral condition inherent in the plan terms (e.g., that the amount will be paid upon the employee's separation from service, which may occur in a future year). Under the final rules, a payment can be delayed where the payment would jeopardize the employer's ability to continue as a going concern.

Where a series of payments is scheduled to start after the forfeiture risk lapses, the short-term deferral rule applies separately to each payment if the entire payment is made during the 2½-month period. Therefore, where a payment has been designated as a separate payment, it may qualify as a short-term deferral even if the employee has a right to subsequent payments under the same arrangement. In contrast, where a payment has not been designated as a separate payment (such as a life annuity payment or a series of installment

payments treated as a single payment), any initial payments in the series are not short-term deferrals even if paid within the 2½-month period.

STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

The final regulations liberalize the stock option and stock appreciation rights exemption from §409A in the proposed regulations.

Use of Subsidiary Stock—Going up the Corporate Chain

Under the proposed regulations, employers could not grant options using stock of a non-public subsidiary of a publicly held corporation. The final rules, however, allow employers to use stock of the service recipient corporation or any entity up the corporate chain, but not down the chain or sideways (a brother-sister corporation). When going "up" the corporate chain, there generally must be at least a 50% ownership interest, although this can be reduced to 20% based on legitimate business concerns. These rules also apply to private companies.

Use of Any Class of Common Stock Permitted

The proposed rules exempted stock options from §409A to the extent they were granted on common stock that had the highest aggregate value of any class of common stock. The final regulations generally allow any class of common stock to be used unless it has a preference as to dividends, other than a liquidation preference.

Reduced Look-back Period for Illiquid Start-up Companies

The proposed regulations provided a limited safe harbor for illiquid start-up companies in existence for less than 10 years in determining FMV. This safe harbor was of limited use as an IPO or liquidity event within one year of the grant date made the safe harbor unavailable. The final rules reduce the look-back period to six months for IPOs and three months for change-in-control events.

Who Can Perform a Valuation?

The final rules state that, in addition to a qualified appraiser, a valuation can be performed by someone with more than five years' experience in private equity. For public companies that want to use their average stock price over a period of up to 30 days, the commitment to grant the stock right generally must be irrevocable before the beginning of the specified period.

Determining the Grant Date

The proposed regulations did not define an option's "grant date." The final regulations set the grant date by reference to the incentive stock option ("ISO") regulations.

Extensions of Exercise Periods

The proposed regulations provided that an extension of an option beyond December 31 of the year in which the option would have otherwise expired or, if longer, 2½ months was deferred compensation subject to §409A. However, employers often provided longer extensions for legitimate business purposes, such as an exit incentive plan or an involuntary employment termination. The final rules permit an extended exercise period that does not last longer than the lesser of the option's original maximum term or 10 years from the date of grant.

SEVERANCE PAY

The final rules also make several changes with regard to severance benefits. The proposed regulations suggested that severance arrangements could be treated as deferred compensation. This caused problems for public companies because payments of §409A deferred compensation cannot begin until six months after a separation of service

for "specified employees." This situation was particularly difficult where the employee initiated the termination for "good reason" in one year, but the event constituting the good reason happened in an earlier year. In such cases, it would be almost impossible to characterize the resulting payments as short-term deferrals exempt from §409A. The final rules, however, treat certain "good reason" terminations initiated by the employee as involuntary separations, making these payments eligible for the short-term deferral rule even if they are paid immediately upon separation.

The proposed regulations exempted from §409A severance benefits that did not exceed the lesser of two times the service provider's annual compensation or two times the §401(a)(17) annual limit on compensation ($225,000 for 2007 and periodically indexed for inflation). The final rules state that this exemption applies to payments up to this limit even if the entire amount of severance pay exceeds the limit. Amounts that exceed the limit are subject to §409A unless another exemption applies.

PLAN AGGREGATION RULES

The proposed regulations treated all similar types of deferred compensation for a single employee as a single plan. Violating §409A with respect to any aspect of a "plan" triggered §409A penalties on all benefits under the aggregated plans. The proposed regulations only provided four types of plans under §409A: account balance plans, non-account balance plans, severance plans and "other" plans (generally, equity-based compensation arrangements). The final regulations add additional categories, such as split-dollar life insurances, reimbursement plans and non-exempt stock rights. The final rules also permit employers to subdivide account balances into elective plans and non-elective plans, and amounts deferred under foreign plans from amounts deferred under domestic plans.

INITIAL ELIGIBILITY ELECTIONS

In the case of rehires and transfers, the initial eligibility deferral election rules apply to an employee if he or she has not been eligible to earn benefits under the plan (applying the plan aggregation rules) for at least 24 months. In addition, a special initial eligibility rule applies to non-elective excess benefit plans, allowing participants to make an initial deferral election immediately after the first year in which they earn a benefit under the plan.

SEPARATION FROM SERVICE

The final regulations permit employers to use a "same-desk" rule prohibiting NQDC distributions in the event of certain asset sales. The final regulations also allow a NQDC plan to define a separation from service as including phased retirement if the definition is specified no later than the date on which the time and form of payment are elected or otherwise specified.

SPECIFIED EMPLOYEES

Section 409A makes specified employees who receive their benefits on account of separation from service wait until six months after the separation date or, if earlier, the employee's date of death. The final regulations allow employers to use an "over-inclusive" list of specified employees if the alternative method is reasonably designed to include all specified employees. The final regulations also provide new rules for determining the list of specified employees in a variety of M&A situations such as the merger of two public companies, the acquisition of a private company by a public company, a spin-off of one public company from another public company, and an IPO.

CHANGE IN CONTROL DISTRIBUTIONS

The final regulations lower the threshold for a change in control of a corporation from 35% to 20%. The final regulations also clarify the rules under

which a NQDC plan may be terminated and liquidated upon a change in control; only the plans covering the employees of the acquired company need to be terminated; and the acquirer's plans need not be terminated. The regulations also further reduce the period during which an employer cannot adopt a new NQDC plan after terminating and liquidating a NQDC plan upon a change in control from five to three years.

ADMINISTRATIVE FLEXIBILITY

The final regulations clarify that a payment will be considered made on a specified date if it is paid not earlier than 30 days before such date or if the payment or payments are made by the end of the calendar year in which the applicable payment date occurs or, if later, the 15th day of the third month following such payment date. In addition, if an employer fails to make a payment on the specified date due to an oversight, the payment is treated as made on the specified date if the employee makes reasonable, good faith efforts to collect it, such as providing timely notice to the employer that the payment is due and unpaid.

ISSUES NOT ADDRESSED

The final regulations do not address the calculation and timing of amounts required to be included in income under §409A, nor the reporting and withholding requirements applicable to employers that sponsor plans subject to §409A. The regulations allow taxpayers to continue to rely on the interim rules allowing partnerships to rely on the stock option exemption described above when issuing profit interests. The IRS intends to issue further guidance on these topics.

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