DEFERRED COMPENSATION PROGRAMS
UNDER SECTION 409A AND THE FINAL REGULATIONS

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1. **Reasons for Section 409A.**

2. **Background.**

As part of the American Jobs Creation Act of 2004, new Section 409A of the Internal Revenue Code (the "Code") was enacted to regulate nonqualified deferred compensation plans. Section 409A made **5** major changes to the operation of nonqualified deferred compensation plans as follows:

a. Expands the scope of what constitutes a nonqualified deferred compensation plan to encompass a wide variety of executive compensation arrangements, including severance pay programs, employment agreements with severance benefits, and equity based compensation.
b. Specifies when elections to defer compensation under such plans must be made.
c. Specifies the **time** when amounts from a nonqualified deferred compensation plan can be distributed, and when elections regarding the **form** of distributions can be made and modified.
d. **Prohibits** plans from permitting the acceleration of distributions from nonqualified deferred compensation plans.
e. Provides significant penalties on plan **participants** if Section 409A is violated, including immediate income taxes, the imposition of a **20%** excise tax, underpayment of tax interest penalties and a Form W-2 reporting.

3. **Plans Subject to 409A.**

a. Nonqualified Deferred Compensation Plans (i.e., account balance and non-account balance – defined benefit plans).
b. Supplemental Executive Retirement Plan ("SERPs").
c. Equity-Based Arrangements.
d. Severance Arrangements.
e. Employment Agreements.
f. Foreign Plans.

4. **Plans Not Subject to Section 409A.**

a. Qualified Retirement Plans.

b. Section 423 Stock Purchase Plans even if stock is issued at a discount (excluding foreign plans).
c. Certain Severance Arrangements fitting within Several Exceptions.
d. Bona fide Sick Leave, Vacation or Compensatory Time Plans.
e. Disability Plans.
f. Death Benefit Plans.
g. Certain Taxable Medical Expense Reimbursement Plans ("MERPs"), satisfying Section 105 and 106.
h. Health Savings Accounts ("HSAs") and Archer Medical Savings Accounts.
i. Payments satisfy the **2½** month Short-Term Deferral Rule.
j. Tax Equalization Payments (for excess foreign taxes), as long as payments are made no later than the **later of**: the end of the **2nd** taxable year beginning after the tax year in which an employee's U.S. return is required to be filed; or the second tax year of the employee beginning after the later of the year a foreign tax return is required to be filed or the year to which the equalization payment applies.
k. Contributions to Social Security "Type" Systems in Foreign Jurisdictions (under Totalization Agreements).
l. Certain Indemnifications, Liability Insurance and Legal Settlement of bona fide wrongful termination, discrimination and FLSA claims.
m. Broad Based Foreign Retirement Plans.
n. Educational Plans under Section 127.
o. Transfers of Property subject to Section 83 of the Code.

5. **Plan Aggregation Rules**.

All amounts deferred with respect to an employee under all plans in a particular category are treated as deferred under a single plan. These rules apply for purposes of distributions, terminating plans, etc. The Final Regulations expanded the number of categories to include the following:

a. Account Balance Plans. The Final Regulations provide that account balance plans may be subdivided into categories for **elective** and **nonelective** contributions to the extent amounts may be separately identified. For example, the right to a Matching Contribution on an Elective Deferral will not be treated as an Elective Deferral Arrangement.
b. Non-Account Balance Plans (i.e., defined benefit plans).
c. Separation Pay Arrangements.
d. Split Dollar Life Insurance.
e. Reimbursement Plans or In-Kind Benefits.
f. Stock Rights.
g. Foreign Plans.
h. Other Plans.

The primary importance of the "Plan Aggregation Rules" is to limit the impact of a **failure** to comply with Section 409A. For example, under the Proposed Regulations, the failure for an arrangement under which a participant makes deferral elections to comply

with Section 409A would also have affected the participant's nonelective account balance plan benefits, such as a Matching Contribution or Employer Discretionary Contribution. Under the Final Regulations, the elective deferrals constitute a separate plan, and any adverse consequences will not affect non-elective contributions. Furthermore, the special rules that apply to initial deferral elections for newly eligible participants apply on a plan by plan basis. Thus, the expanded number of plan categories allows the use of the favorable deferral rules in more instances.

6. **Grandfather Rule.**

   a. Section 409A does **not apply** to deferrals **earned** and **vested** before **December 31, 2004**.
   b. Pros and Cons of relying upon the **"Grandfather"** rule, or amending and restating arrangements.
   c. To amend and restate; or draft new programs as of January 1, 2005 or January 1, 2008?
   d. The Final Regulations provide that to the extent a plan contained a haircut provision permitting immediate distributions contingent on a reduction in benefits, the haircut provision need not be removed retroactively for periods prior to January 1, 2008, as long as a plan **operated in compliance** with the applicable transition guidance, and no haircut provisions have been used after December 31, 2004. The plan can simply be amended as of January 1, 2008.
   e. An employer must be able to demonstrate that a plan was operated in compliance with the transition guidance.

7. **Drafting Issues.**

   a. Effective January 1, 2005.
   b. Effective January 1, 2008 relying on transitional leave.

8. **Deferral of Compensation**

   Exists if an employee or other service provider has a **legally binding right** during a year to receive compensation during a year that has not been actually or constructively received and that is payable in a later year.

9. **Substantial Risk of Forfeiture vs. Legally Binding Right.**

   a. Legally binding right may occur even if there is a substantial risk of forfeiture, such as vesting.
   b. If compensation can be unilaterally reduced or eliminated by the service recipient after the services have been performed; there is no legally binding right to compensation.

10. **If the reduction or elimination the compensation is based on a condition that is unlikely to be exercised, then there is a legally binding right.**

   a. Unfettered discretion to reduce means no legally binding right.
   b. Discretion based on a condition means a legally binding right.
   c. Discretion exercised by a related party or party over who the compensation recipient has control means a legally binding right.

11. **Short-Term Deferral Exception.**

   a. Paid by the later of:
      i. **2½** months after the end of the employee's taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or
      ii. **2½** months after the end of the employer's taxable years in which the amount is no longer subject to a substantial risk of forfeiture.
   b. Payments can be made after the **2½** month period if due to unforeseeable administrative or solvency issues.
   c. It is not necessary to expressly state that the payment is made within the **2½** month period. However:
      i. If not expressly stated, payment actually must be made within the **2½** month period (no delays allowed).
      ii. If not, an automatic violation of Section 409A will occur.

12. **General Deferral Election Rule.**

   a. Deferral elections must be made before the year in which compensation is earned.
   b. Election must include the **time** and **form** of payment.
   c. Must be **irrevocable** as of the deadline for making the election.
   d. Election may remain in place from year to year as long as it becomes irrevocable by the deadline date (e.g., December 31).

13. **Deferral Elections for New Participants.**

   a. Election may be made within **30** days after becoming eligible to participate in a plan.
   b. Election only applies to compensation earned after the election, such as salary and bonus.
   c. For excess benefit plans, an employee generally becomes a participant automatically when they are no longer eligible to receive benefits under the qualified plan. For purposes of initial deferral elections, a participant under an excess plan will be treated as becoming eligible to participate on the **first day of the year following** the year in which the participant first accrues a benefit. A participant may thereafter make an election within **30** days after this date, even though the election may apply to benefits that accrued under the Plan before the date of election. This exception was made since employees will not have **knowledge** of their ability to make elections.

d. An election to defer compensation may be made on or before the **30th** day after an employee obtains a legally binding right to compensation, provided the election is made at least **12** months in advance of the earliest date upon which the forfeiture condition may lapse. This provision may allow employees to elect to defer payments under Long-Term Incentive Plans ("LTIPs"), **30** days before they have a right to a benefit, and **1** or **2** years before payment will be made.

e. The Final Regulations provide that with respect to separation benefits paid upon an involuntary separation from service, subject to bona fide arm's length negotiations, the initial deferral election may be made any time before the employee attains a **legally binding right** to payment. The Final Regulations expand this rule to include voluntary terminations, as long as no "legally binding" right exists. The exception addresses both a choice between a current and a deferred payment, and the establishment of the **time** and **form** of deferred compensation. These rules were enacted to avoid having a late initial deferral election and to avoid the potential plan aggregation rules to eliminate the ability to make an election. The rule, however, does not apply to pre-existing legally binding of rights, including legally binding rights subject to a substantial risk of forfeiture. Any change in the **time** and **form** of payment under an arrangement with a legally binding right is required to follow the general **5** year delay in payment rule. It should be noted that payment of unvested deferred compensation can be an impermissible acceleration of benefits (subject to a facts and circumstances test).

14. **Performance-Based Compensation.**

a. Election may be made as late as **6** months before the end of the performance period, provided payment is not substantially certain at election.

b. Need performance period of at least **12** months.

c. Performance Based Compensation definition is similar to Notice 2005-1.

   i. Contingent on the satisfaction of organizational or individual criteria, including subjective criteria; and

   ii. The criteria must be established in writing within the first **90** days of the performance period, and that the achievement of the criteria must be substantially **uncertain** at the time the criteria are established.

d. The Final Regulations only require an employee to provide services from the **later of** the date the performance period starts or when the performance criteria are established through the date of an initial deferral election, for performance-based compensation plans. Thus, if an employee terminates employment before the end of the performance period, the election is still valid.

e. The Final Regulations also clarify that a deferral election for performance-based compensation must be made before the compensation has becomes **readily ascertainable**, which is different from the **substantially certain** provisions of the Proposed Regulations. Where the right to a specified amount is subject to a performance requirement being met, the amount is treated as readily ascertainable when it is substantially certain the performance requirement will be met. Accordingly, any minimum amount that is calculated and for which the

performance requirement entitling the employee to payment is substantially certain to be met will generally be treated as readily ascertainable and may not be deferred under the **6**-month election rule for performance compensation. For example, if a minimum bonus of **$10,000** is payable, it cannot be deferred under the **6**-month rule for performance-based plans.

f. In general, compensation payable to an employee equal to the value of appreciation in stock will not be performance-based compensation. However, if the right to compensation is subject to a performance-based vesting requirement, such compensation may be performance-based compensation.

15. **Payments must be made no earlier than:**

a. A fixed date or a fixed schedule.

b. Upon the occurrence of the following events:
   i. Separation from service.
   ii. Death.
   iii. Disability.
   iv. Change in Control.
   v. Unforeseeable emergency.

The Preamble to the Final Regulations reflects that an employee may receive a distribution for unforeseeable emergencies without needing to consider the ability to obtain hardship distributions from a qualified plan or distributions from other nonqualified plans. Presumably, the public policy favoring preservation of qualified retirement assets is behind this relief.

16. **Plan must have an objectively determinable date of distribution.**

a. Payment is treated as objectively determinable if made by the later of:
   i. End of year containing the designated date; or
   ii. The **15th** of the **3rd** month following the designated date.

b. A plan can just specify a year, without specifying a particular day in the year. For purposes of the subsequent election rules, the distribution date is deemed to be January 1 of such year.

c. The Final Regulations allow the timing of a distribution to be based upon an objective formula, such as profits.

d. A popular provision is to provide that payment is made as soon as administratively feasible, but in no event later than the **15th** day of the third month following the end of a calendar year. The Final Regulations provide that such a provision will be a specified payment date only if the period during which such payment may be made is restricted to either a specified taxable year or a period of not more than **90** days (as long as the employee cannot elect the year of payment).

e. Deferred compensation that is scheduled to be paid on a specific date may be paid before the specific date as long as payment is not earlier than **30** days before the specific date, and the service provider cannot designate the tax year of the payment.

f. The plan or arrangement may also specify a period (e.g., January 1 through July 1 of a specific year) during which payment is to be made. However, the period may not be stated as **"not later than July 1,"** because that would permit payment before January 1.

A payment will generally be made on a fixed date if payment or payments are made by the end of the calendar year in which a specified fixed payment date occurs or, if later, the 15th day of the third month following such fixed date would. For example, where payment is scheduled to be made upon the death of an employee, the payment is timely if made on a before the later of December 31 of the calendar year in which death occurs, or the 15 day of the third month following the date of death.

17. **Multiple payments events are permitted.**

a. Different payment schedules can apply to different payment events.
b. Alternate payment schedules if a specific triggering event occurs on or before one (but not more than one) of the specified dates.

18. **Delay of Payments Permitted.**

a. Payment is administratively impracticable, which was unforeseen.
b. Reasons beyond the employer's control.
c. Payment would jeopardize employer's solvency as a going concern.
d. Payment would not be deductible under Section 162(m) – (dealing with the **$1** million compensation deduction limits), which could not have been anticipated when the legally binding right arose.
e. Payment would violate securities laws, loan covenants or similar contractual arrangements.
f. Employer's refusal to pay benefits.
g. Bona fide disputes of payments.

19. **Separation from Services.**

Benefits under all nonqualified deferred compensation programs, including severance agreements, may generally **not** be paid until after a Separation from Service. The term "Separation from Service" means an individual is no longer employed by an employer on account of a termination of employment, retirement, Disability or death. Consistent with Proposed Treasury Regulations, no Separation from Service will occur if an employee continues to perform services as a consultant or an employee in excess of any amount of time permitted under such guidance.

a. **Leave of Absence**. For purposes of Section 409A, the employment relationship is treated as continuing in effect while an employee is on military leave, sick leave, or other bona fide leave of absence, as long as the period of leave does not exceed **6** months, or if longer, as long as the employee's right to reemployment

with the employer is provided either by statute or contract. Otherwise, after a **6**-month leave of absence, the employment relationship is deemed terminated.

b. **Part-Time Status**. Whether or not a termination of employment occurs is determined based upon all facts and circumstances. However, in the event that services provided by an employee are **insignificant**, a Separation from Service shall be deemed to have occurred. For purposes of Section 409A, if an employee is providing services to an employer at a rate that is at least equal to **20%** of the services rendered, on average, during the immediately preceding **3** full calendar years of employment (or such lesser period), and the annual compensation for such services is at least **20%** of the average annual compensation earned during the final **3** full calendar years of employment (or such lesser period), no termination will be deemed to have occurred since such services are **not insignificant**.

c. **Consulting Services**. Where an employee continues to provide services in a capacity other than as an employee, a Separation from Service shall not be deemed to have occurred if the former employee is providing services at an annual level that is **50%** or more of the services rendered, on average, during the immediately preceding **3** full calendar years of employment (or such lesser period) and the annual remuneration for such services is **50%** or more of the annual remuneration earned during the final **3** full calendar years of employment (or such lesser period).

The Final Regulations provide that the single employer test uses a **50%** test under Section 414. However, a **20%** threshold can also be used to define a single employer if valid business reasons exist. This new rule creates several planning opportunities. The specified percentage must be put into a plan document.

In many situations, executive employees wish to remain employed on a part-time or consulting basis following a traditional retirement, and employer appreciate the continuity such arrangements provide. However, these new rules require careful consideration to determine if anticipated severance or supplemental retirement benefits may be paid.

20. **Separation Pay Arrangements**.

In general, all "separation pay arrangements" will be treated as a form of deferred compensation under Section 409A, unless a specific regulatory exemption applies. It should be noted that an arrangement may cover a single individual. The Preamble to the Proposed Regulations explained that the Treasury and the IRS used the term **"separation pay"** rather than **"severance pay"** specifically to avoid confusion with other provisions of the Code that used the term severance pay. Therefore, any separation pay arrangement, regardless of what it is called or the type of agreement in which it is contained, must be analyzed under the general framework of the Section 409A rules. For example, if the plan provides for payment upon an involuntary termination, and the right to payment does not "vest" until a termination of employment occurs, there would not be a deferral of compensation as long as all payments are made within **2½** months after the

end of the calendar year in which the termination occurs. If, however, the separation payments are to be made over a longer period, the arrangement must comply with Section 409A, unless it fits within one of the exclusions described below.

The Proposed and Final Regulations **exempt** the following arrangements from the definition of deferred compensation under Section 409A:

a. For purposes of only the 2005 calendar year, payments to "non-key" employees pursuant to severance plans that are classified as welfare plans under the Department of Labor ("DOL") Regulations. The DOL Regulations provide that a severance plan is any program that provides a benefit to employees for a period of less than **24** months. If the benefits are paid for a longer period, they are considered to be a retirement benefit under ERISA. For purposes of this provision, a key employee is an officer earning more than **$150,000** in 2008 (with a limit of no more than **50** employees, or if less, the greater of **3** or **10%** of **all employees**); a **5%** owner; or a **1%** owner having annual compensation of more than **$150,000**.

b. Arrangements providing for severance pay upon an individual's actual involuntary separation from service or pursuant to a window program if the arrangement provides that:

   i. The separation pay (**not including** certain expense reimbursements, in kind benefits, direct service recipient payments, and de minimis payments discussed below) does not exceed **2** times the **lesser of**:

      A. The sum of the employee's annual (Section 415) compensation for services for an employer (or an individual's net earnings from self-employment for services as an independent contractor), for the calendar year preceding the calendar year in which the separation from service occurs, as **adjusted** under the Final Regulations for any increases during the preceding year expected to be permanent; or

      B. The maximum that may be taken into account under qualified retirement plans under Section 401(a)(17), which is **$230,000** in 2008; and

   ii. The separation pay is paid **no later** than December 31 of the **second calendar year**, following the calendar year in which the separation from service occurs. Under this rule, an individual who terminates employment in January, 2008 could actually receive payments until the end of 2012. However, since the maximum severance benefit is **$460,000**, this rule was not thought to be available for many senior executive terminations.

It is important to note that the Final Regulations clarify that payments under a program meeting this exception up to the **$460,000** limit **avoid** the **6**-month delay in payment rule.

The Final Regulations also clarify that payments up to the monetary limits can qualify for the exceptions, even if additional payments are made. Thus, only the excess **over** the limit (i.e., over **$460,000**) is subject to Section 409A. Specified

employees will therefore not incur the economic hardship of **6** months without salary as previously anticipated.

c. Arrangements for employees covered under collective bargaining agreements ("CBAs") that provide for severance pay upon an involuntary separation from service or pursuant to a window plan. In order to meet this requirement, the agreement must be contained in the CBA; the severance payments be the subject of arms length negotiations; the CBA must be a bona fide agreement between employer representatives and employers; and the CBA must be the result of good faith bargaining.

d. Arrangements that entitle an employee to certain reimbursements that are otherwise **excludable** from gross income (such as COBRA benefits), reasonable outplacement expenses, or reasonable moving expenses (or reimbursement for loss on the sale of a primary residence) actually incurred and directly related to the termination of service. The Final Regulations expand this exception to certain taxable medical reimbursements. Such reimbursements were required to be **incurred** and paid by December 31 of the **second calendar year** following the calendar year in which the separation from service occurs. However, the Final Regulations allow **payment** to be by the end of the **third calendar year** for expenses (except for medical expenses) **incurred** by an employee.

e. Arrangements that entitle an employee to in kind benefits or payment by an employer directly to the person providing goods and services to the employee. For example, the provision of free cable services to terminated employees of a cable company will not result in the deferral of compensation. In-kind benefits are still subject to the **2** year rule above (and not a **3** year rule).

f. Arrangements that entitle an employee to reimbursement or other payments or benefits that do not exceed **$5,000** in the aggregate. Thus, **de minimis benefits** are exempted from the scope of Section 409A. This amount is increased in the Final Regulations to equal the Section 402(g) limit, which is **$15,500** in 2007.

g. Arrangements that provide for payment upon an involuntary separation and that are structured to meet the requirements of the short-term deferral exemption generally available under Section 409A (i.e., the **2½** month rule). Under this provision, any severance benefits paid to an employee by the **later of** the **15th** day of the third month following the employers' first taxable year in which the involuntary separation occurs or the **15th** day of the third month following the end of the employee's first taxable year in which the separation occurs, is **not subject** to Section 409A. For calendar year employers, this means that all severance benefits must be paid by the March 15 following the calendar year in which the termination occurs. In most instances, employers will seek to rely upon this exemption **due to its simplicity**. More importantly, under the short-term deferral rules, if the benefits are not paid within the **2½** month period, such as March 15 above, but are paid by the December 31 in which the **2½** month rule should be satisfied, no penalties will be imposed under Section 409A. In order to obtain this relief, specific reference must be made to the **"payment date"** to satisfy the short-term deferral rule. Accordingly, detailed written agreements will help avoid penalties under Section 409A.

h. Awards attributable to litigation between an employee and an employer for wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers compensation statutes, regardless of whether such claims arise under federal, state, local or foreign laws, even where settlements or awards are treated as compensation, are generally not considered to be a form deferred compensation under Section 409A. In addition, the Final Regulations provide that the payment of, or reimbursement for, attorney's fees incurred in connection with the enforcement of such claims are not deferred compensation. Obviously, all claims must be bona fide claims and not intended to allow awards to act as a form of deferred compensation, and cannot accelerate payments under any other programs subject to Section 409A.

i. Although not exempt from Section 409A, for separation pay that is subject to bona fide arms length negotiation at the time of any involuntary termination, the election as to the **time** and **form** of payment may be made on or before the date an employee obtains a "**legally binding**" right to payment. This rule permits an employer to negotiate the payment of benefits for a period longer than and for an amount greater than those provided above, if specific **payment dates** exist. Thus, any employment agreements providing for severance benefits or severance benefits must be drafted to include **"fixed" payment dates**.

If an employee has an unvested deferred compensation benefit and an employer offers to pay it upon a termination of employment, it is an **impermissible acceleration**. Thus, negotiations in connection with terminations must be carefully considered.

The Final Regulations clarify that payments for multiple reasons may all be excluded from Section 409A (e.g., severance up to **$460,000**, reasonable moving and outplacement and a de minimis **$15,500** payment).

21. **Post Employment Reimbursements (by the end of the 2nd year after termination of employment increased by 3 years if incurred by the end of the second year):**

a. Business expense reimbursements (**3** years to pay).
b. Medical expenses (must still receive under the **2** year rule).
c. In-kind benefits, such as office space (no extra year – **2** years to pay).
d. Moving and relocation payments (including amounts relating to the loss on a residence).
e. Outplacement expenses.
f. Other **de minimis** payments or reimbursements of less than **$5,000**, as increased to the Section 402(g) limit in the Final Regulations.

22. **Good Reason Terminations.**

Many employment agreements provide that an employee may voluntarily terminate employment if certain events occur within **6**-months following a change in control, including assignment to duties inconsistent with the status as an officer or reduction in

base salary. The legislative history to Section 409A and the Preamble to the Proposed Regulations specifically raise questions concerning such provisions.

a. **Legislative History of Section 409A**: The legislative history provides that the Secretary of the Treasury is authorized to prescribe Regulations to define certain terms, including a substantial risk of forfeiture and when a substantial risk of forfeiture should be disregarded. The legislative history provides as follows:

   "It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risk of forfeitures should be disregarded in cases in which they are a illusory or are used in a manner inconsistent with the purpose of the provision. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction."

   The above language was intended to address the issue of whether a substantial risk of forfeiture exists, postponing income when an executive has the ability to elect to receive a severance benefit following a change in control. It would appear that upon the change in control, the mere ability to receive payment, even contingent upon adverse employment actions such a reduction in compensation or authority, could result in taxation.

b. **Preamble to the Proposed Regulations**: The Preamble to the Proposed Regulations further identify that commentators requested that payments upon a termination of service for **"good reason"** be treated as a right that is subject to a substantial risk of forfeiture. The IRS and Treasury acknowledge that such provisions are typical in change of control events. However, the Proposed Regulations provide as follows:

   "The Treasury Department and the IRS are not confident that amounts payable upon a voluntarily separation from service, and amounts payable only upon a termination of services for good reason, always may be adequately distinguished. Furthermore, even if the types of good reasons sufficient to constitute a substantial risk of forfeiture could be elucidated, the application of such a rule would involve intense factual determinations, leaving taxpayers uncertain in their planning and creating a significant potential for abuse. Accordingly, the Regulations do not treat the right to a payment upon a separation from service for good reason categorically as a right subject to a substantial risk of forfeiture. However, the Treasury Department and the IRS request comments as to what further guidance may be useful with respect to arrangements containing these types of provisions."

c. **Final Regulations**. The Final Regulations provide a safe harbor definition of "**good reason**". Payments or benefits paid on an involuntary termination or a termination for "good reasons" may qualify as separation pay or under the short-term deferral exception. The Final Regulations provide that if the right to a payment is contingent upon a voluntary separation from service following an

occurrence that constitute "good reason" for the employee to terminate employment, the right may be treated as payable only upon an involuntary separation from service where the good reason condition is such that the employee's separation from service is effectively involuntary for purposes of Section 409A.

Although the Final Regulations outlined the actions which could have a material negative effect on the employment relationship, most employers will follow the following "safe harbor" to ensure that a **good reason** termination exists:

i. The employee must separate from service within a limited period of time, not to exceed **1** year following the reason for the good reason termination.
ii. The **amount**, **time** and **form** of payment upon a **voluntary** separation from service for good reason must be **identical** to the **amount**, **time** and **form** of payment upon an **involuntary** separation from service.
iii. The employee must be required to provide notice of the existence of the good reason condition within a period not to exceed **90** days of its initial existence.
iv. The employer must be provided a period of **at least 30** days during which it may remedy the condition entitling the employee to terminate his or her employment.
v. For purposes of this provision, the good reason conditions may consist of one or more of the following conditions arising without the consent of the employee:
    A. A material diminution in the employee's base compensation.
    B. A material diminution in the employee's authority, duties or responsibilities.
    C. A material diminution in the authority, duties, or responsibilities of the supervisor to whom the employee is required to report, including a requirement that the employee report to a corporate officer or employee instead of reporting directly to the board of directors or a similar entity.
    D. A material diminution in the budget over which the employee retains authority.
    E. A material change in the geographic location at which the employee must perform services.
    F. Any other action or inaction that constitutes a material breach of the terms of an employee's employment agreement.

It is interesting to note that a change in Board composition is not covered as a "safe harbor" good reason.

d. **<u>Practical Implications</u>**. The practical implications of the above rules are as follows:

i. The IRS was pushed very hard to come up with some exceptions where a termination for good reason is deemed to be a substantial risk of forfeiture. The Final Regulations accomplish this goal.

ii. If a document does not follow a safe harbor and a termination is not for good reason, then payments may be ineligible for either the short-term deferral rule or the separation from pay exceptions (i.e., since no involuntary termination is deemed to occur). In other words, if there is no substantial risk of forfeiture, there is no involuntary termination, and an executive still has **too much control** over the payment of benefits. Therefore, all employment agreements must be carefully reviewed.

iii. For public companies, an employee who terminates employment under a good reason provision will still **not be able** to receive payment for a **6**-month period of time.

iv. For nonpublicly traded companies, the continuance of a good reason termination should not present significant difficulties, since there is no taxation under the old constructive receipt rule and payments may be made within the **6**-month period of time following the triple trigger (i.e., change in control, diminution of duties, and election to receive benefits).

v. While the **6**-month delay in payment rule will still apply, properly designed employment or severance agreements may be structured to minimize the effects of the **6**-month rule, such as where the **$450,000** exception is used.

23. **Structuring Reimbursement Arrangements Subject to Section 409A.**

Reimbursement and in kind benefits that are not otherwise excludable from income and do not qualify for separation pay exceptions are subject to Section 409A. Final Regulations provide that such arrangements can meet the requirements that benefits be made pursuant to a fixed schedule if the following requirements are satisfied:

a. The arrangement must reimburse only those expenses incurred over an objectively defined period.

b. The amount of the reimbursable expense or in kind benefit in one year cannot affect the amount of expenses or in kind benefits in another taxable year. For example, an employer may provide for the payment of country club memberships equal to **$10,000** per year for **3** years. However, an agreement may not be structured to reimburse up to **$30,000** for a **3** year period of time, since this would violate the prohibition against carryover amounts. It would appear this prohibition against carryover amounts does not apply to medical reimbursement arrangements.

c. Payments must be made no later than the end of the employee's taxable year following the taxable year in which the expenses incurred; and

d. The reimbursement or in kind benefit right cannot be subject to **liquidation** or **exchange** for another benefit.

24. **Indemnifications.**

a. Under Final Regulations, the right to the payment to cover legal expenses arising out of an employee's duties will **not be subject to Section 409A** to the extent the

reimbursement is permissible under law. This rule applies whether the payment is made directly to the employee or through the purchase of liability insurance, and it covers payments made by the employer to settle a bona fide claim against the employee arising of services to an employer.

b. Liability insurance for directors and officers ("D&O Coverage") is **not** a deferred compensation under the Final Regulations.

c. The Proposed Regulations did not address **gross-ups** to pay taxes incurred under Section 409A or other expenses. The Final Regulations, however, provide that a right to a tax gross-up payment or the reimbursement of expenses related to a tax audit or litigation may give rise to deferred compensation subject to Section 409A. These payments will be treated as **"complying"** with the requirements for Section 409A if the Agreement pursuant to a payment is made provides that the payment will be made by the end of the tax year following the tax year in which the related taxes are remitted to the taxing authority or, if no taxes are paid, the end of the taxable year following the year in which the audit or litigation is completed.

25. **Separation from Service of Specified Employees of publicly traded companies.**

a. Payments cannot be made for at least **6** months after separation from service of specified employees.
b. A Plan must state how the **6**-month delay is implemented.
c. For periodic payments an employer may delay payment and make an employee whole for lost earnings (such as prime plus **2%**).
d. **6**-month delay does not apply to distributions on account of:
   i. Domestic Relations Orders.
   ii. Payment of employment taxes.
   iii. Certificate of divestiture under federal ethics rules.

26. **Identification of Specified Employees.**

a. Key employee under the top-heavy rules is:
   i. Officer having compensation in excess of **$150,000** in 2008 per year.
      A. There is no additional guidance on who is an officer.
      B. No more than **50** employees can be considered officer.
   ii. **5%** owner (without limit).
   iii. **1%** owner with compensation for more than **$150,000** (without limit).
b. Key employees are determined on a **"controlled group"** basis.
c. Foreign owned companies must give consideration to determining key employees.

27. **A Look-Back Rule is Used to Determine of Specified Employees.**

a. Pick an identification date.
b. Determine who are key employees under the top heavy rules as of that date.
c. They will be key employees for Section 409A purposes for the **12**-month period commencing on the **1st** day of the **4th** month after the identification date.

d. The Final Regulations permit an employer to name any date as the **"Specified Employee Identification Date"** and to identify as the **"Specified Employee Effective Date"** any date that is **no later than** the first day of the fourth month following the Specified Employee Identification Date. The alternative rules and definitions may be included in the Plan document or provided for elsewhere. However, an alternative may only be used after all corporate action has been taken to make the alternative binding for purposes of all deferred compensation plans of the employer (such as use of a Board resolution). Final Regulations also impose certain restrictions on making changes to these alternatives to prevent manipulation. Accordingly, an employer could identify December 31 as the specified employee identification date and the specified employee effective date for **simplicity** in administration.

e. The Final Regulations also authorize the use of certain less burdensome methods of complying with the specified employee rules. For example, a Plan may delay payments for all employees by **6** months, regardless of whether the employees are specified employees. This approach avoids the need to identify individuals as specified employees.

f. A plan may use an alternative method of identifying specified employees, as long as the alternative method is:
   - i. Reasonably designed to include all specified employees; and
   - ii. Used an objectively determinable standard providing no direct or indirect election to any employee regarding the application of the rules; and
   - iii. Results in no more than **200** employees being treated as specified employees at any one time.

28. **"Subsequent Distribution Election" Rules.**

Participant may make an election to change the **time** or **form** of a distribution after an amount has been deferred only if:

a. "Subsequent election" may not take effect for **12** months;

b. Must be at least **12** months before date payments are scheduled to be made/begin; and

c. Must provide for a new distribution date that is at least **5** years after the date the distribution would have otherwise been made.

29. **Permitted acceleration to lump sum.**

a. Change will not constitute an impermissible acceleration of a distribution if the other **12** month/**5** year timing rules are followed.

b. Changing among actuarially equivalent annuity forms before any payments have been made is not subject to the **12** month/**5** year rule.

c. In non-elective plans (e.g., SERPs), the time and form of payment for an amount must be specified when an individual attains a legally binding right to the amount.
   - i. This is treated as an initial deferral election under the rules.
   - ii. Any change to the time or form thereafter is subject to the subsequent election rules.

30. **If a Plan provides for multiple distribution events, the subsequent election rules apply to each distribution event separately.**

    a. For example, if a lump sum distribution is payable upon the **earlier of** attaining age **65** or a separation from service, subsequent election rules may apply to delay the age-based event to age **70** while election based upon separation from service remains **unchanged**.
    b. Must consider earlier of vs. later of elections.

31. **The Final Regulations continue to allow separate application of the rules to payments in a series.**

    a. For example, a plan may treat installment payments as separate payments for purposes of the subsequent election rules.
    b. A big question is whether recordkeepers will administer this type of a feature, and any costs.

32. **Prohibition on Acceleration of Distributions.**

    a. Section 409A generally "prohibits" an acceleration of payment under a nonqualified deferred compensation plan.
    b. The Proposed Regulations provided several helpful exceptions in addition to those previously provided in Notice 2005-1:
        i. A plan may provide that an intervening distributable event (e.g., death) may override an existing distribution schedule (e.g., installments) already in pay status.
        ii. If a participant obtains a distribution under a nonqualified plan due to an unforeseeable emergency or a 401(k) plan for hardship, a plan may permit the **cancellation** of a participant's deferral election.
        iii. De minimis payments of **$10,000** or less could be cashed out under the Proposed Regulations.
        iv. The Final Regulations permit cash outs up to the Section 402(g) Section 401(k) limit (**$15,500** in 2007).
        v. The Final Regulations allow the addition of payments for death, disability and unforeseeable emergency without violating the acceleration of benefit rule.
        vi. A plan may provide for an accelerated distribution to pay the amount a participant must include in income as a result of a Section 409A violation.
        vii. Tax Gross Ups and Reimbursements do not result in prohibited acceleration.

33. **Equity-Based Compensation.**

    a. Consistent with the legislative history and Notices, nonqualified stock options are not subject to Section 409A provided they are:
        i. Granted for not less than FMV at date of grant;

ii. Taxable under section 83 of the Code; and
iii. Contain no features for the deferral of compensation.

b. The Proposed and Final Regulations expanded this exemption to treat SARs as being exempt from Section 409A; similarly to stock options –
   i. Compensation from a SAR based on FMV at date of grant and exercise price never less than FMV at grant.
   ii. Regardless of whether the SAR is settled in cash or stock.
   iii. Regardless of whether the SAR is based on stock of a public or private corporation.
   iv. A SAR does not include any feature for the deferral of compensation.

c. Stock awards may only be based on "service recipient stock."
   i. Defined as including:
      A. Only common stock tradable on an established securities market; or
      B. If none, that class of common stock that has the greatest aggregate value of any class of common stock issued and outstanding (or common stock with substantially similar rights to such class). The Final Regulations provide any class of stock that is common stock for purposes of Section 305 of the Code may qualify as service recipient stock, with several exceptions. First, any class of stock that has a preference as to distribution, other than distributions of the service recipient stock and distributions upon liquidation, cannot be service recipient stock. Second, stock cannot be service recipient stock if it is subject to a mandatory repurchase obligation (other than a right of first refusal) or a put or call right if the stock price under the right is based on a measure other than fair market value.
   ii. Service recipient stock does not include preferred stock or stock that includes a mandatory repurchase obligation or a put or call right not based upon fair market value.

d. **"Service recipient"** generally defined in accordance with the controlled group aggregation rules in Sections 414(b) and (c) of the Code, except:
   i. A stock right, plan or arrangement may provide that the single employer rules are applied by using a **50%** instead of **80%** threshold; and
   ii. A stock right, plan or arrangement may instead provide for a threshold of **20%** where the use of such stock with respect to stock rights is based upon **"legitimate business criteria"** (e.g., in the case of a joint venture employing former employees), so long as used consistently for all compensatory stock rights.

e. Determination of FMV.
   i. Public corporation FMV is determined in variety of ways (e.g., based on the closing price on the trading day before or the trading day of the grant).
   ii. Private corporation FMV is determined:
      A. Through the reasonable application of a reasonable valuation method, as determined based on the facts and circumstances; or

B. Under a safe harbor valuation method under which the consistent use of such method is presumed to result in the fair market value of the stock, including:

1. Valuation by an independent appraisal that satisfies the requirements applicable to ESOPs; and
2. Formula-based valuations.

iii. The Final Regulations potentially expand the valuation rules. Under the Proposed Regulations, a valuation method for nonpublic stock was generally presumed to be reasonable only if the valuation method was used by the service recipient for **all** compensatory and non-compensatory purposes. The Final Regulations **relax** this requirement considerably, and simply require the valuation method to be used consistently for purposes of stock transfers to the issuer or any person who owns more than **10%** of the total combined voting power of all classes of stock. Final Regulations also liberalize the presumption of reasonableness with regard to stock of start-up companies.

iv. The Final Regulations also provide that an employer could use one valuation method for the exercise price and another method for establishing a payment for buy back purposes, which was precluded under the Proposed Regulations

f. The Final Regulations permit the extension of the terms of a stock right, which will not be treated as an additional deferral feature, if the exercise price is not extended beyond the **earlier of**:

i. The original maximum term of the stock right; or

ii. **10** years from the original grant date.

g. Furthermore, the extension of a stock right will not be treated as an additional deferral feature, regardless of the length of extension, if the extension is made at a time when the exercise price of the stock is greater than fair market value of the stock.

34. Distributions on Plan Termination.

An employer may terminate a plan and distribute benefits if:

a. All plans of the **same type** maintained by the employer (e.g., all account balance plans) are terminated with respect to all participants;

b. No payments are made within **12** months of the plan termination (other than those that would have been paid absent the termination);

c. All payments are made within **24** months of the plan termination; and

d. The employer does not adopt a plan of the same type (e.g., a new account balance plan) for a period of **5** years following the date of plan termination.

These rules in combination with the plan aggregation rules are important for mergers and acquisitions.

35. **Transition relief is extended to December 31, 2008.**

a. Applies if the plan is operated in good faith compliance with the provisions of Section 409A and the IRS guidance.
   i. Not required to follow the Proposed Regulations.
   ii. Compliance with Proposed Regulations is deemed good faith.

b. Plan is amended by December 31, 2008.

c. All plans and arrangements providing for a deferral of compensation must be amended to comply with Section 409A by **December 31, 2008**.

d. A written plan document can consist of several documents, including deferral election forms. The Final Regulations provide that general provisions of a plan to nullify provisions that do not comply with Section 409A, or to supply required specific plan terms, are disregarded. Thus, if a plan does not have basic required provisions it will not comply with Section 409A even with a "**savings**" clause. Employers must therefore use caution in incorporating certain provisions by reference.

e. The Final Regulations provide that to the extent a plan contained an impermissible provision, such as a haircut provision permitting immediate distributions contingent on a reduction in benefits, the haircut provision need **not be removed retroactively** for periods prior to January 1, 2008. As long as a plan has operated in compliance with the applicable transition guidance, and no haircut provisions have been used after December 31, 2004, the plan can simply be amended as of January 1, 2008. Employers must consider if they wish to retroactively amend and restate plans as of **January 1, 2005** as intended, or **January 1, 2008**.

f. The Final Regulations provide that plans providing for a deferral of compensation must be established in writing, and generally provides that a plan will be considered established on the lastest of the following dates:
   i. It is adopted;
   ii. It is effective;
   iii. When the material terms are set forth in writing. Material terms include:
      A. Amount of deferred compensation.
      B. Conditions for initial and subsequent elections.
      C. Timing of payments.
      D. Forms of payment.
      E. Provisions that may override other provisions, such as the percentage of change for a separation from services (i.e., **80%**, **50%** or lower).
      F. Specified employees need not be defined in a document and may be better addressed in a **Board Resolution** to be consistent in all plans within a controlled group.

In general, for nonelective plans, the date a plan is established may relate back to the date the participant has a legally binding right to the deferred compensation, as long as the Plan is in writing by the end of the year or within **2½** months after the beginning of the next year if payment is being deferred beyond the end of the

next year. A plan with Employee Salary Deferral Elections must be in writing no later than the date the initial deferral is required to be made.

g. An employer must be able to document that a plan was operated in compliance with the transition guidance.

36. **Transition Relief Applies to:**

a. Drafting plan documents.
b. Changing distribution elections.
c. "Piggyback elections" of distribution option with qualified plan.
d. Second Election Opportunity has been extended and prior elections can be still be changed.

37. **Inadvertent Amendment Materially Modifying a Plan can be Rescinded.**

a. Must be rescinded within the year.
b. No participant could receive an additional benefit or take advantage of the provision.

38. **Linked Plans.**

a. Many employers previously maintained plans under which employees could defer, and often receive Matching Contributions for amounts they could not otherwise contribute to a qualified Section 401(k) Plan due to the ADP/ACP Tests. These plans were frequently **"linked"** since changes and elections under the qualified plan would similarly change the amount deferred under the nonqualified plan. After the enactment of Section 409A concerns existed that a change in election under the qualified plan, that increased the amount deferred under the nonqualified plan, would violate the deferral election rules.
b. The Proposed Regulations provided relief so a change in a deferral election under a qualified plan, that changed the amount deferred under a nonqualified plan, would **not violate** Section 409A if the change did not cause the amount deferred under the nonqualified plan to increase or decrease by more than the Section 402(g) limitation. Similarly, the Proposed Regulations provided that a change in an election under the qualified plan that caused the amount credited to the account of a participant under a nonqualified plan as Matching Contributions to decrease, would not violate Section 409A if all actions or inactions on the part of the participant did not cause the total amount credited to the nonqualified plan to decrease by more than the Section 402(g) limit.
c. The Final Regulations refine the Proposed Regulations in several regards. Initially, the Final Regulations clarify that Section 402(g) limit includes the amount of Catch-Up Contributions; and the Section 402(g) limitation on the maximum permissible **"changes"** to the amount credited to the participant's accounts under the nonqualified plan is applied separately to elective deferrals and to Matching Contributions.

d. The IRS reviewed a linkage for qualified and nonqualified plans to permit amounts to be credited to a participant's account under a nonqualified plan at the rate elected under the qualified plan, once the participant had made the maximum permissible contributions under the qualified plan. The IRS indicated that this approach could result in a late deferral election or an impermissible revocation of a deferral election, which would be inconsistent with the legislative intent under Section 409A. The Final Regulations do, however, allow such a linkage if a changed election only results in increased amounts being credited as Matching Contributions under the nonqualified plan and the increase is limited to the amount that would have been creditable under the qualified plan, but for the ADP/ACP Tests or the Section 401(a)(17) limitations. For example, if an employee earns **$300,000** per year, and elects to contribute **10%** of compensation to the qualified retirement plan first, with the balance going to a nonqualified plan, such an election is permissible. The first **$15,500** will be deferred to the qualified plan (or **$20,500** if the individual is over age **50**). Thereafter, the balance would be deferred to the nonqualified plan. Furthermore, to the extent the employer provided for Matching Contributions under both a qualified and nonqualified plans equal to **$.50** on each **$1** of Employee Savings Contribution, once the qualified plan limits was exceeded, the balance could be deferred under the nonqualified plan. A question exists how the refund of excess contributions would be addressed.

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