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Client Alert

A report for clients and friends of the Firm

April 2007

The Deferred Compensation Rules: IRS Issues Long-Awaited Final Regulations Under 409A

- **Every traditional deferred compensation plan, employment agreement, severance arrangement and equity plan must be reviewed and most likely amended by December 31, 2007.**

- **Proskauer will be hosting a seminar in June on the issues described in this Client Alert.**

The Treasury Department and the Internal Revenue Service recently issued the long-awaited final regulations under Section 409A of the Internal Revenue Code ("409A"). 409A imposes detailed requirements regarding the timing and method of elections and payments of amounts deferred under "nonqualified deferred compensation plans," which is defined broadly and includes arrangements such as severance and certain equity based compensation. If the requirements of 409A are not satisfied, the employee recipients of deferred amounts under a plan subject to 409A are subject to adverse tax consequences. The rules apply to all participants and not only executives, and to all types of employers, including for-profit and not-for-profit entities and private and public companies.

The final regulations retain the structure of the proposed regulations issued in the fall of 2005,[1] but include certain revisions made in response to comments received by the public. The major differences reflected in the final regulations and summarized in this Client Alert include:

(1) specificity with regard to documentary compliance;

(2) the expansion of the rules regarding stock rights;

(3) the significant liberalization of the rules regarding separation pay, including the clarification of the treatment of reimbursement and fringe benefit arrangements and the treatment of certain "good reason" terminations as involuntary separations from service; and

(4) the relaxation of the plan aggregation rules.

The final regulations maintain a December 31, 2007 deadline for amending arrangements to comply with 409A. 409A is generally effective as of January 1, 2005. The Treasury Department and the Internal Revenue Service have issued various Notices providing transition relief since 409A became effective. The final regulations generally are effective for taxable years starting on January 1, 2008. Prior to January 1, 2008, taxpayers may continue to rely on a good faith interpretation of the law and the previous guidance.

Documentary Compliance

As noted above, the deadline for plan sponsors to amend plan documents to comply with the documentation requirements of 409A remains December 31, 2007.

Written Document Requirement

A plan document must specify, in writing, at the time an amount is deferred, the amount the plan participant (referred to under 409A as the "service provider") has a right to be paid and the payment schedule or payment triggering events. The final regulations clarify that the written document requirement may be satisfied through the use of multiple documents, including, for example, a deferral election document. With respect to a deferral election, the plan must specify no later than the time by which the election is required to be irrevocable the conditions under which that election may be made. The

[1] For a summary of the proposed regulations, please refer to our previous clients alert entitled "Update on New Deferred Compensation Rules: Proposed Regulations Issued Under Code Section 409A" at http://www.proskauer.com/news_publications/client_alerts/content/2005_10_11

plan, need not, however, specify the conditions under which an accelerated payment will be made except as explicitly required under the final regulations. For example, a plan need not set forth in writing that it may provide for acceleration of the time or schedule of payment to an individual other than the service provider to the extent necessary to satisfy a qualified domestic relations order.

Six Month Delay

The final regulations require that a plan document or agreement specify that distributions to a service provider who is a "specified employee"[2] may not be made before the date that is six months after the date of separation from service or, if earlier, the date of death. Such a provision must be set forth in writing with specificity on or before the date the service provider first becomes a specified employee.

Savings Clauses are Ineffective

Significantly, the final regulations state that general provisions that purport to nullify plan terms or to supply specific plan terms to comply with 409A are disregarded. Accordingly, if a plan contains terms that do not meet the requirements of 409A or fails to contain a necessary term, a general savings clause will not prevent the plan from violating the requirements of 409A.

Stock Rights

The final regulations generally adopt the provisions of the proposed regulations, which excluded from the scope of 409A incentive stock options, rights under qualified employee stock purchase plans and restricted stock. The final regulations also retain the exclusion from 409A for non-qualified stock options and stock appreciation rights ("SARs"); provided that such stock rights are granted at fair market value on the date of grant and issued on service recipient stock without any additional deferral feature. The final regulations expand the definition of "service recipient stock" allowing such stock options and SARs greater ease in qualifying for exclusion from 409A and clarify the valuation methods for service recipient stock. The final regulations also reflect a significant change from the proposed regulations by relaxing the restrictions on the extension of the exercise periods of non-qualified stock options and SARs.

Service Recipient Stock

- **Permissible Classes of Stock.** In order for non-qualified stock options and SARs to be excluded from 409A, such stock rights must be granted on "service recipient stock." The final regulations reflect a departure from the proposed regulations, which required that the class of common stock underlying an award had to be the publicly traded common stock (if applicable) or the class of common stock with the highest aggregate value outstanding and prohibited any preferential rights. Under the final regulations, any class of common stock that would qualify as common stock under Section 305 of the Internal Revenue Code may be used regardless of whether the class of stock is subject to transferability restrictions or buyback rights (any such buyback rights must reflect the fair market value of the stock at the time of purchase). Common stock is also permitted to maintain preferences with respect to liquidation rights, but may have no additional preferential rights (e.g., preferential dividends).

- **Permissible Issuers of Stock.** The final regulations expand the definition of "service recipient stock" to include the stock of the corporation for which the service provider is directly providing services on the date of grant and the stock of any upstream corporation that maintains a "controlling interest" in the corporation to which the service provider is directly providing services on the date of grant. The final regulations retain the "controlling interest" threshold of a 50% interest established under the proposed regulations and provide that in some circumstances the threshold may be as low as 20% where there exists a legitimate business criteria for issuing stock rights at such corporate level. Reliance upon the legitimate business criteria requirement is evaluated on a facts and circumstances basis and requires that there be a sufficient nexus between a service provider receiving a stock right and the entity issuing the underlying stock to serve a legitimate non-tax business purpose.

Valuation

- **General.** In order for non-qualified stock options and SARs to be excluded from 409A, such stock right must be granted with an exercise price that is no less than the fair market value of the underlying stock on the date the stock right is granted and the exercise price can never be less than such fair market value (except as adjusted in certain corporate transactions).

- **Consistent Use.** The final regulations eliminate the requirement of use of a consistent valuation method set forth in the proposed regulations. Under the final regulations, a service recipient may use one valuation method for purposes of establishing an exercise price and another valuation method for purposes of establishing fair market value on exercise. The final regulations, however, make it clear that once an exercise price has been established, that exercise price may not be changed through the retroactive use of another valuation method.

- **Readily Tradable Stock.** The final regulations generally retain the rules under the proposed regulations regarding the valuation of stock readily tradable on an established securities market.[3] For purposes of setting the exercise price of a stock option, the final regulations permit the use of an average selling price during a specified period that is within 30 days before or 30 days after the date of grant, provided that the commitment to grant the stock right with an exercise

[2] A "specified employee" is a key employee of a corporation any stock of which is publicly traded on an established securities market.

price set using such an average selling price be irrevocable before the specified period. In this case, the service recipient must designate the recipient of the stock option, the number of shares subject to the stock option and the method for determining the exercise price, including the period over which the averaging will occur, before the beginning of the specified period. The final regulations clarify, however, that the use of an average selling price method for determining fair market value of a stock right may deviate from the prescribed method of establishing the price averaging method and period if mandated by applicable foreign law and such stock right is granted in accordance with such applicable foreign law, so long as the averaging period does not exceed 30 days.

- **Stock Not Readily Tradable.** Under the final regulations, there are two general methods by which stock that is not readily tradable may establish a fair market value on the date of grant of a stock right—the reasonable valuation method and the presumptive method.

  Reasonable Valuation Method. The final regulations retain the concept that a valuation of stock based upon a reasonable application of a reasonable valuation method that takes into account all available information material to the value of the company will be treated as reflecting the fair market value of the stock. It is not necessary for the value to be determined by an independent appraiser.

  Presumptive Method. The final regulations also provide that, in certain circumstances, a valuation of stock presumptively reflects the fair market value of the stock, which presumption is rebuttable only by a showing by the IRS that the valuation is grossly unreasonable. The presumption is available where the valuation is based upon (i) a qualified independent appraisal within 12 months of the grant (relying upon such valuation), (ii) a generally applicable repurchase formula (applicable for compensatory and noncompensatory purposes), which satisfies the determination of fair market value under Section 83 of the Internal Revenue Code or (iii) in the case of illiquid start-up companies, a valuation performed by a qualified individual or individuals[4] applied at a time that neither the service recipient nor the service provider could reasonably anticipate a change in control event in the next 90 days or an initial public offering within the next 180 days.

Extension of Stock Rights

The final regulations provide for a significant, favorable change in the treatment of an extension to the exercise period of a stock right for purposes of maintaining the exclusion from 409A. The proposed regulations generally treated an extension of a stock right exercise period (other than certain limited extensions) as a modification that constituted a deferral of compensation and subjected such stock right to 409A. Under the final regulations, an extension of the exercise period of a non-qualified stock option or SAR will not be treated as an additional deferral feature or a modification of such stock right provided that any such extension does not extend the exercise period beyond the earlier of (i) the expiration of the original term of the stock right or (ii) 10 years from its original date of grant. The final regulations will also permit such an extension of the exercise period for any "underwater" stock right (*i.e.*, where the exercise price is greater than the fair market value).

Separation Pay Plans

The final regulations generally follow the proposed regulations concerning separation pay plans, but also contain new rules addressing the treatment of "good reason" terminations. The final regulations also clarify that separation pay refers only to compensation that is conditioned upon a separation from service. The exceptions from the definition of deferred compensation for certain types of separation pay have been retained and supplemented and include: (i) certain bona fide collectively bargained arrangements; (ii) certain arrangements providing separation pay due solely to an involuntary separation from service or participation in a window program in limited amounts and for a limited period of time; (iii) certain foreign separation pay arrangements; (iv) certain reimbursement arrangements providing for expense reimbursements or in-kind benefits for a limited period of time following a separation from service; and (v) certain rights to limited or "safe harbor" amounts of separation pay.

Involuntary Separations from Service; Window Programs

- **Exemption.** Consistent with the proposed regulations, the final regulations generally provide an exemption from 409A for separation pay made solely in connection with an involuntary separation from service or participation in a window program that does not exceed the lesser of two times (i) the employee's annualized compensation, based upon his annual rate of pay for the prior taxable year (adjusted for any increase that was expected to continue indefinitely), and (ii) the limitation under Section 401(a)(17) of the Internal Revenue Code for the year in which the service provider has a separation from service ($225,000 for 2007), and is paid in full no later than December 31 of the second year following separation from service. Under the proposed regulations, to the extent that separation pay

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[3] Stock will be considered "readily tradable on an established securities market" where it is regularly quoted by brokers or dealers making a market for such stock.

[4] An individual will be deemed "qualified" if a reasonable person, upon being apprised of the individual's knowledge, experience, education and training would reasonably rely on such individual's advice with respect to such valuation. For this purpose, significant experience generally means five or more years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending or other comparable experience.

exceeded the foregoing limitation, the entire amount of separation pay would have been subject to 409A. However, under the final regulations, only amounts in excess of the foregoing limitation will be subject to 409A. Accordingly, under the final regulations, separation payments of up to $450,000 (for a service provider who earned $225,000 or more in 2007) may be made immediately upon separation from service without regard to the requirements of 409A, including the six-month delay rule for specified employees.

- **Characterization of Separation.** The final regulations provide that whether a separation from service is involuntary is determined based on all of the facts and circumstances. Any characterization of the separation from service as voluntary or involuntary by the service provider and the service recipient in the documentation relating to the separation from service is rebuttably presumed to properly characterize the nature of the separation from service.

"Good Reason" Terminations

- **General.** The final regulations incorporate the concept of good reason into the application of the rules related to involuntary separations from service. In order for a good reason termination to qualify as an involuntary separation from service, the event resulting in such termination must involve actions by the service recipient resulting in a material negative change in the service relationship with the service provider, such as a material negative change in the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received. In addition, avoidance of 409A may not be the principal purpose of the inclusion of a good reason termination right.

- **Safe Harbor.** The final regulations also contain a good reason safe harbor provision. Payments under an arrangement with a good reason provision will be considered payable in connection with an involuntary separation from service if the following criteria are satisfied: (i) the separation from service must actually occur within a period not to exceed two years following the initial existence of the good reason condition; (ii) the amount, time and form of payment must be substantially identical to the payment due on an actual involuntary separation from service; (iii) the service provider 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, and the service recipient must be provided with at least a 30-day cure period; and (iv) good reason must consist of one or more of the six conditions specifically enumerated in the final regulations. Use of any definition other than the safe harbor will require a facts and circumstances determination, which if incorrect, could result in the severance amount not being treated as paid as a result of an involuntary termination. In that case, because there would not be a substantial risk of forfeiture, if a "specified employee" is involved, there will be a violation of 409A unless a six month delay in the payment is imposed.

Reimbursement Arrangements and In-Kind Benefits

The final regulations clarify that a right to a future benefit that is excludible from income (such as health coverage excludible from income under Section 105 of the Internal Revenue Code) will not be treated as a deferral of compensation under 409A. In addition, the final regulations contain several provisions governing reimbursement plans (including plans providing in-kind benefits) that constitute nonqualified deferred compensation plans for purposes of 409A and address ways to design such arrangements to comply with the payment timing requirements of 409A. The final regulations also clarify that reimbursement by a service recipient of a service provider's payments for medical expenses are generally not treated as a deferral of compensation during the service provider's continuation period under COBRA. Consistent with the proposed regulations, the reimbursement of certain expenses, such as reasonable outplacement expenses and reasonable moving expenses in connection with a separation from service, are exempt from 409A to the extent that the service provider incurs these eligible expenses no later than the end of the second year after the year in which the separation occurs (even if the arrangement extends beyond that date), although the final regulations permit actual reimbursement to occur through the end of the third year following separation.

Separations from Service

The final regulations simplify the standard for determining whether a separation from service has occurred by focusing solely on the amount of services to be provided and by eliminating the proposed regulations' focus on the amount of compensation paid. A separation from service will be presumed where the level of bona fide services rendered is less than 20% of the average level of services provided during the previous 36-month period. A service provider will be presumed not to have separated from service where the level of bona fide services rendered continues at a level that is 50% or more of the average level of services provided during the previous 36-month period. For a change to the level of services between 20% and 50% of the average level of services provided during the previous 36-month period, no presumption will apply and the determination will be based on the surrounding facts and circumstances.

Transfers within a Controlled Group

For purposes of a transfer of a service provider between related companies in a controlled group of corporations, such transfer will not be treated as a separation from service if the transfer is to an entity that is 50% or more owned or under common control with the transferring entity. However, a plan may specify a greater percentage of up to 80% or, to the extent that the definition of service recipient for purposes of determining a separation from service is based on legitimate business criteria, a smaller percentage as low as 20%.

Asset Sale Transactions

The final regulations address the treatment of employees in the context of an asset sale by allowing the parties to an asset purchase agreement to decide whether the seller's employees who continue in the same position with the purchaser of the assets will be treated as separating from service. Under the final regulations, the default rule provides that a transfer of employees in an asset sale transaction will result in a separation from service with the seller. However, the parties may agree in a bona fide, arm's length negotiation whether the transferred employees are deemed to incur a separation from service under 409A, so long as the affected employees are treated consistently regardless of position and such treatment is specified by the closing date of the transaction.

Determination of Specified Employees; Corporate Transactions

The final regulations have added default rules for determining who is a "specified employee" by clarifying the rules under the proposed regulations in the context of various types of corporate transactions such as mergers, spin-offs and initial public offerings. For example, in the context of a public company merger transaction, the specified employees immediately following the transaction will be determined by combining the lists of specified employees of all service recipients participating in the transaction, ranking such specified employees in the order of their amount of compensation, and treating the top 50 of such specified employees as specified employees of the post-transaction entity. The final regulations also provide an alternative method to identify specified employees so long as such method is reasonably designed to include all specified employees, is an objectively determinable standard, and results in either all service providers or no more than 200 service providers being identified in the class of specified employees as of any date.

Short-Term Deferral Rule

Payments made within two and one-half months after the later of (i) the end of the service provider's taxable year and (ii) the end of the service recipient's taxable year in which a payment is no longer subject to a substantial risk of forfeiture continue to be exempt from 409A pursuant to the short–term deferral rule. The final regulations clarify that the short–term deferral exemption will not apply where payment can occur outside of the short-term deferral period.

The proposed regulations provided that the short-term deferral exemption could continue to apply if a payment was delayed where such payment would jeopardize the service recipient's solvency, and such insolvency was unforeseeable at the time the service provider obtained the right to payment. The final regulations expand on this rule by generally providing that the short-term deferral exemption will continue to apply where a payment is delayed because such payment would jeopardize the ability of the service recipient to continue as a going concern.

The final regulations also provide that in the case of a series of payments, the short-term deferral rule applies separately to each payment. Accordingly, where a payment is designated in writing as a separate payment, it may qualify as a short-term deferral, even if the service provider has a right to subsequent payments under the same arrangement that would not satisfy the short-term deferral rule. This rule does not, however, apply in the case of annuity payments or a series of installment payments that are treated as a single payment.

Plan Aggregation Rules

Pursuant to the plan aggregation rules of 409A, a violation under 409A with respect to one plan affects all similar plans of the service recipient. The final regulations divide nonqualified deferred compensation plans into nine separate categories, thereby reducing the potential adverse impact of noncompliance of a particular plan. The aggregation categories are: (i) elective account balance plans; (ii) nonelective account balance plans; (iii) nonaccount balance plans; (iv) separation pay plans; (v) reimbursement plans and arrangements; (vi) split-dollar life insurance arrangements; (vii) foreign plans; (viii) stock rights; and (ix) any other types of plans.

Arrangements Linked to Qualified Plans

Consistent with the proposed regulations, the final regulations do not permit the time and form of payment under a nonqualified deferred compensation plan to be governed by the time and form of payment under the qualified plan to which it is linked. However, an adjustment to an elective deferral under a nonqualified deferred compensation plan that is linked to a 401(k) plan solely as a result of statutory maximums imposed on contributions to the qualified 401(k) plan is permitted.

Exceptions from 409A Coverage

The final regulations clarify that a legally binding right to receive a nontaxable benefit does not provide for a deferral of compensation for purposes of 409A, unless the service provider receives that right in exchange for, or has the right to exchange the right for, an amount that would be includible in income. The final regulations also include an exception from coverage under 409A for rights to certain educational assistance benefits for the service provider (but not his family members).

A plan which provides for the indemnification of, or the purchase of liability insurance coverage for, a service provider is generally not treated as providing for a deferral of compensation under 409A. The final regulations also provide that 409A generally does not apply to amounts paid as settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act or worker's compensation statutes, as well as reimbursement of legal fees incurred in connection with enforcement of such claims. This exception does not, however, apply where such an award or settlement is in fact a substitute for, or a restructuring of, preexisting deferred compensation subject to 409A.

457(f) Plans

In response to commentators' requests for clarification concerning the application of the short-term deferral rule to 457(f) plans, the final regulations provide that for purposes of the short-term deferral rule, amounts are treated as paid when included in income under Section 457(f) of the Internal Revenue Code, whether or not actual or constructive payment occurs. Accordingly, if income inclusion under Section 457(f) of the Internal Revenue Code results from the lapse of a substantial risk of forfeiture that is also treated as a substantial risk of forfeiture under 409A, the amount included in income will be considered a short-term deferral for purposes of 409A. This rule will allow many 457(f) plans to avoid the application of 409A.

Back-to-Back Arrangements for Hedge Fund Managers

The final regulations preserve the relief provided in the proposed regulations for "back-to-back" deferral arrangements. However, the final regulations clarify that the rules addressing back-to-back arrangements apply regardless of whether the deferral arrangement between the individual and the hedge fund manager is actually subject to 409A as long as each deferral arrangement that is part of the overall back-to-back scheme complies with 409A. The final regulations do not provide relief for so called "reverse" back-to-back arrangements where payments to individuals providing services to the hedge fund manager are required when payments are made from the hedge fund to the manager under a 409A compliant deferral arrangement between the hedge fund and the manager (*e.g.*, on a termination of the investment management arrangement with the fund). However, the preamble specifically states that the issue is being studied by the IRS. Finally, the final regulations do not address the application of 409A to partnership arrangements and provide no guidance concerning the prohibition against certain off-shore funding arrangements.

Further Guidance

The final regulations do not address the calculation and timing of amounts required to be included in income under 409A or the reporting and withholding requirements applicable to service recipients. The Treasury Department and the IRS have indicated that they intend to issue further guidance with respect to these requirements.

At the same time that the final regulations were issued, the IRS issued Notice 2007-34 which includes guidance regarding the application of 409A to split-dollar life insurance arrangements. Notice 2007-34 provides that certain modifications of split-dollar life insurance arrangements necessary to satisfy the requirements of 409A will not be considered material modifications for purposes of the grandfather rules applicable to such arrangements.

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Breakfast Seminar SERIES

Proskauer Rose will be hosting a breakfast seminar on these issues in June. Details will be provided in the near future.

For more information on this seminar, please visit www.proskauer.com

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Proskauer's Employee Benefits and Executive Compensation Law Practice Group includes over 50 attorneys with significant and diverse tax, executive compensation, and employee benefits law experience. The Employee Benefits and Executive Compensation Law Practice Group at Proskauer Rose LLP counsels clients on the full spectrum of benefit and compensation issues, communicating technical and complex legal concepts in an intelligible, pragmatic manner. The following individuals serve as contact persons with respect to this Client Alert and would welcome any questions you might have.

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