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OVERVIEW OF DEFERRED COMPENSATION ARRANGEMENTS UNDER SECTION 409A

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Section 409A was added to the Internal Revenue Code as part of the Jobs Creation Act of 2004, enacted on October 22, 2004. This outline has been prepared based on the statutory language of 409A, IRS Notice 2005-1 (published December 20, 2004), Treas. Reg. 1.409A-1 (issued April 10, 2007), and IRS Notices 2007-78, 2007-86, 2007-89, and 2007-100.

I. WHAT IS NONQUALIFIED DEFERRED COMPENSATION?

A. Types of Arrangements.

1. Plans, contracts, arrangements permitting employees (usually top tier executives) to delay being taxed on some of their compensation by deferring the receipt of that compensation until a later point in time. ***Examples*** include:

   a. Voluntary programs funded in whole or part by the executives' contributions, in which they elect to delay receiving some of their own salary or bonus compensation.

   b. Company-funded programs, to provide golden handcuffs.

   c. Programs that are linked to qualified plans and are intended to permit executives to accumulate more for retirement than under qualified pension, profit-sharing and 401(k) plans, where accumulations are capped by IRS-imposed limits.

2. According to numerous surveys on executive compensation, upwards of 80% of larger companies offer some type of nonqualified deferred compensation plan to their executives.

B. <u>Not "Tax-Qualified."</u>

1. Not designed to meet the requirements of IRC Section 401(a), thereby allowing for significant latitude in plan design.

2. ***Examples***:

   a. No minimum coverage or eligibility requirements.

   b. No limits on contributions or benefits.

   c. No restrictions on how contributions are allocated among participants.

   d. No minimum vesting requirements.

3. The trade-off for this flexibility is somewhat less favorable tax treatment than for qualified retirement plans. For example:

   a. The employer may not take a current deduction for contributions made to the nonqualified plan until participants receive distributions of their benefits and are taxed on them (whereas contributions to qualified plans can be deducted currently in the year they are made, subject to certain IRS limits).

   b. Investment earnings are taxed currently to the employer and do not compound on a tax-deferred basis as they do with qualified plans.

   c. Participants are fully taxed on their benefits when they receive them; they cannot roll them over to an IRA or other qualified plan on a tax-deferred basis.

C. <u>General Exemption From ERISA.</u>

1. Provided a nonqualified arrangement is a "top hat" plan covering only a select group of highly compensated employees (typically 5%-8% of workforce), it is exempt from ERISA's:

   a. Fiduciary requirements.

   b. Plan design and funding requirements.

   c. Substantially all of ERISA's reporting and disclosure requirements.

2. It is subject to ERISA's claims procedure requirements.

II. BACKGROUND ON IRC 409A.

A. What Is 409A?

IRC 409A applies to nonqualified deferred compensation that is earned or that vests after December 31, 2004 (subject to certain transition rules).

B. Why Was 409A Enacted?

To prevent executives from manipulating and abusing deferred compensation, especially in financially troubled companies. (Enron, MCI WorldCom, Global Crossing scandals).

C. When Did 409A Take Effect?

1. 409A applies to compensation that is earned or vested after December 31, 2004.

2. The final regulations took effect January 1, 2008—meaning that from an ***operational compliance*** point of view, all deferred compensation programs and arrangements must be interpreted and administered in good faith compliance with the new rules now; however, the deadline for ***documentary compliance*** has been extended until December 31, 2008—meaning that all deferred compensation programs, plans, contracts, and arrangements must be memorialized in written documents that meet the 409A rules by the end of 2008.

D. What Kinds of Limits Does 409A Impose?

409A creates a new regulatory landscape that focuses on 3 major areas:

1. Which arrangements are considered "deferred compensation" subject to the new rules;

2. Rules governing elections to defer compensation; and

3. Distributions of deferred compensation benefits.

E. What Is The Effect Of Failing To Comply With 409A?

1. Immediate income taxation of all amounts under the arrangement, in the year in which the failure occurs or, if later, when the deferred compensation is no longer subject to a substantial risk of forfeiture (reported in Box 12 of Form W2, and subject to income tax withholding by the employer); ***plus***

2. A 20% excise tax imposed on the amount includible in gross income; ***plus***

3. An additional excise tax imposed, equal to the IRS underpayment rate plus 1%.

4. ***Note***: If an operational failure occurs, only the person affected by the failure is subject to current income tax plus the excise taxes. However, if the plan contains impermissible provisions, all persons covered by the plan are at risk for being subjected to current income taxation plus the excise taxes.

III. WHO IS AFFECTED BY 409A?

A. Service Providers.

The person or entity performing the services, including employees and non-employees (such as directors, consultants and independent contractors).

B. Service Recipients.

The person or entity for which services are performed, including all forms of businesses, taking into account controlled group rules using a 50% (rather than an 80%) standard.

C. Aggregation of Plans.

In applying 409A, all plans of the same "type" are aggregated, by the following categories:

1. Elective individual account balance plans.
2. Nonelective individual account balance plans.
3. All non-account balance plans.
4. Stock rights that constitute nonqualified deferred compensation.
5. Separation pay/window plans.
6. In-kind benefits or expense reimbursements.
7. Split-dollar arrangements.
8. Foreign plan deferrals.
9. All other types of deferred compensation.

IV. **<u>WHAT IS (AND WHAT IS NOT) DEFERRED COMPENSATION SUBJECT TO 409A?</u>**

A. <u>"Deferred Compensation" Defined.</u>

1. Must be otherwise taxable compensation in the first place, which is earned in one year and includible in income in a later year. There is a two-part analysis:

2. Participant must have a "*legally binding right*" to compensation that has not been actually or constructively received and included in gross income and that, pursuant to the terms of the plan, is or may be payable in a later taxable year.

   a. No "legally binding right" to the extent that the deferred compensation may be unilaterally reduced or eliminated after the performance of services.

      (i) Based on facts and circumstances.

      (ii) If the discretion to reduce or eliminate the deferred compensation is available or exercisable only upon a condition, then it will be ignored and the executive will be considered to have a legally binding right to the deferred compensation.

      (iii) If the discretion to reduce or eliminate the deferred compensation lacks "substantive significance" (because the executive has effective control over the person retaining the discretion, has effective control over any portion of the compensation of that person, or is a family member of that person), then the discretion will be ignored and the executive will be considered to have a legally binding right to the deferred compensation.

3. The deferred compensation cannot be subject to a "*substantial risk of forfeiture.*"

   a. A substantial risk of forfeiture exists if entitlement is conditioned on the performance of substantial future services by any person.

   b. A substantial risk of forfeiture also exists if entitlement is tied to the occurrence of a condition related to the purpose of the compensation, such as the executive's performance or the company's business activities or organizational goals (*i.e.,* the attainment of a prescribed level of earnings, equity value or an initial public offering).

c. Merely refraining from the performance of services (as in the case of a noncompete) is ***not*** sufficient to constitute a substantial risk of forfeiture.

4. ***Note:*** Deferred compensation under 409A does NOT include compensation whose payment is delayed or deferred until a substantial risk of forfeiture lapses, but then the compensation is paid immediately.

Example: If an employee is promised a bonus equal to a percentage of corporate profits from year 1, which is payable at the end of year 3 as long as the employee continues to be employed by the corporation, then the bonus does not vest until the end of year 3. If the bonus is paid in full when it vests, the bonus will not be considered "deferred compensation" subject to 409A.

B. What Types of Deferred Compensation ***Are*** Covered?

1. Any type of plan, arrangement or agreement that provides for the deferral of compensation, regardless of the number of persons covered.

2. Employment and buy-sell agreements with deferred payments.

3. Voluntary deferred compensation plans.

4. Supplemental retirement plans ("SERPs"); excess benefit plans (those providing for benefits that supplement qualified plan benefits, over and above the limits that apply to the qualified plans); and wrap plans.

5. Incentive compensation and bonus plans (subject to certain exceptions described below).

6. Separation pay plans (subject to certain exceptions described below).

7. Change in control retention and severance plans.

8. Discounted stock options, discounted SARS or membership appreciation rights, restricted share units, phantom stock and other types of equity or synthetic equity compensation.

9. Taxable fringes and other perks, including those frequently found in executive employment agreements.

C. What Types of Deferred Compensation ***Are Not*** Covered?

1. Tax-qualified retirement plans and certain foreign plans.

2. Employee stock purchase plans.

3. Bona fide vacation leave, sick leave, comp time, disability and death benefit plans.

4. A plan providing for taxable educational benefits.

5. Certain indemnification agreements.

6. Certain settlements of wrongful termination, employment discrimination, FLSA and worker's compensation claims.

7. Medical coverage during a COBRA period.

8. The reimbursement of certain other expenses provided upon separation from service (as described below).

D. Plans With Short-Term Deferrals.

1. To qualify for the short-term deferral exception, the plan must, ***by its terms***, be written to require that the deferred compensation be paid no later than 2-1/2 months after the end of the year in which the money becomes fully vested and no longer subject to a substantial risk of forfeiture, and the plan must also be administered so that the service provider actually or constructively receives the payment within that 2-1/2 month period.

2. In order for the short-term deferral exception to apply, the deferred compensation plan must meet the exception in writing and in operations. Thus, a plan will *not* qualify for the short-term deferral exception, even if payments are made within the 2-1/2 month period, if the written terms of the plan do not specify any specific payment date in writing, or if the written terms of the plan specify that payment will be made after the 2-1/2 month period.

3. A significant exception and planning strategy for existing plans.

4. ***Planning tips***:

   a. Consider designing plans with specific features that require that payments be made within 2-1/2 months after the end of the taxable year (*i.e.,* by March 15th of the following year) in which the deferred compensation vests and is no longer subject to a substantial risk of forfeiture.

Example: A bonus plan can be designed to provide that an individual has to be employed on the date that the bonus is paid in order to receive the bonus for the prior fiscal year. For example, bonus is based on 2007 performance and is scheduled to be paid by March 1, 2008, but the bonus plan provides that the bonus will be forfeited unless the employee continues to be employed through the March 1 payment date. Under this structure, the payment of the bonus is subject to a risk of forfeiture (and therefore does not vest) until the date of actual payment. Because the bonus will be paid immediately upon vesting, it will qualify for the short-term deferral exception.

b. Consider putting this in writing in order to take advantage of flexible rules in the regulations (discussed below), which permit payment by the end of the tax year if the specified payment date is missed because it became administratively impracticable to pay by the end of that 2-1/2 month period or due to unforeseeable events.

5. ***Cautionary note***: The short-term deferral exception cannot be used to accelerate deferred compensation payments, as noted above.

Example: If an agreement provides, by its terms, that payment will be made 24 months after vesting, but payment is actually made within 2-1/2 months after the year in which the compensation vests, the short-term deferral rule would not apply and the payment would be viewed as an impermissible acceleration, triggering immediate income taxes as well as the two layers of excise taxes.

E. <u>Certain Separation Pay Arrangements.</u>

1. "Separation pay" for 409A purposes is any compensation where one of the conditions to receiving the payment is a separation from service. It includes:

   a. Payment for voluntary or involuntary separations

   b. Reimbursement of expenses

   c. Any taxable benefits

2. Collectively-bargained separation pay arrangements are not considered to provide for the deferral of compensation under 409A.

3. Separation pay plans providing for payment due to involuntary separation from service, or voluntary participation in a “window” program, are not considered to provide for the deferral of compensation under 409A to the extent all three of the following requirements are met:

   a. The *reason* for the separation pay is due to an “involuntary termination” or under a window program.

      (i) The final regulations clarify what constitutes an involuntary termination and explain that certain resignations for "good reason" may be treated as constructive, involuntary terminations provided certain requirements are met.

      (ii) For example, the regulations establish a safe harbor that a v voluntary separation from service for good reason will be treated as involuntary if three conditions are met:

         (I) The separation occurs within 2 years from the date that there is a material diminution in the service provider's base compensation; in his (or his supervisor's) authority, duties or responsibilities; in the budget over which he retains authority; or in the geographic location at which he must perform services;

         (II) There is a notice and cure period, where the service provider gives the service recipient at least 90 days' notice of these conditions, and at least 30 days to remedy the situation; and

         (III) The amount, time, and form of the payment upon separation from service must be substantially identical to the amount, time, and form of payment that would be due if there were an actual involuntary separation from service.

   b. The *amount* of separation pay, other than reimbursements, does not exceed <u>two</u> times the lesser of the following amounts:

      (i) The executive’s annual compensation for the preceding calendar year (not including benefit plans or compensation resulting from the exercise of stock options, stock awards, or the disposition of the underlying stock); or

(ii) The maximum amount of includible compensation permitted by IRS limits that apply to qualified plans ($230,000 in 2008).

c. The *timing* of the separation pay meets certain requirements:

(i) The payment must be made no later than December 31st of the second calendar year following the year in which the executive separates from service.

Planning tip: Consider designing broadly based severance plans and window programs to conform to these limitations regarding the amount and timing of payments in order to avoid application of 409A. If the amount limit is exceeded, only the excess will be subject to 409A.

4. Individualized separation pay agreements with executives that exceed the amount limitations of the safe harbor described above may nevertheless be exempt from the application of 409A if they are structured to meet the short-term deferral exception, since the right to separation pay upon an involuntary termination of employment is viewed as a nonvested right.

Example: An executive is involuntarily terminated and is negotiating his separation pay arrangement, which will provide for him to receive a lump-sum payment of severance. 409A will not apply as long as the terms regarding the time and form of payment of his severance are agreed upon before he signs the agreement and thereby obtains a legally binding right to the payment. However, if he already has in place a current contractual right to severance payments, he cannot renegotiate the timing of severance payments after he has been terminated, because it is the event of his termination of employment that gives rise to his legally binding right to the payment.

5. Certain payments and reimbursements of other benefits provided to an executive who has separated from service will not be considered to provide for the deferral of compensation:

a. Reimbursements that are made to a separated service provider, as long as (i) there is an objectively determinable definition of expenses eligible for reimbursement or in-kind benefits to be provided; (ii) the time of payment is objectively determinable at the time of termination; and (iii) the expenses are reimbursed by December 31st of the calendar year following the calendar year in which the expense was incurred.

b. Medical coverage during the COBRA continuation period.

c. Other nontaxable benefits.

d. The right to indemnification or insurance coverage as a result of a legal claim related to the service provider's performance.

e. Aggregate payments for items that do not exceed the annual limit on 401(k) deferrals for the year of separation ($15,500 in 2008).

f. Reimbursement for certain deductible moving and outplacement expenses, as long as they are incurred before the end of the second year following separation from service and the reimbursement is made by the end of the third year following separation from service.

g. Tax gross-ups can be reimbursed as long as they are paid by the end of the tax year following the tax year in which the taxes are remitted. Similar rules apply to reimbursements of tax audit or litigation expenses.

F. <u>Stock Options, Stock Appreciation Rights, Restricted Stock, Phantom Shares and Other Equity Arrangements.</u>

1. Final regulations provide detailed guidance about which equity can be considered "service recipient stock", modifying percentage tests that apply to controlled group determinations, joint ventures and similar arrangements. Generally, common stock must be used, although it is permissible to use preferred stock that is only preferred as to liquidation rights, not as to dividend rights.

2. <u>Incentive Stock Options/Employee Stock Purchase Plans.</u> 409A does not apply to IRC Section 423 employee stock purchase plans or to incentive stock option plans, unless a modification is made which results in the loss of ISO treatment. (***Note***: Not all changes that would disqualify an option from being considered an ISO—such as having shares withheld for FICA taxes—will create problems under 409A).

3. <u>Nonqualified Stock Options.</u> The final regulations exempt nonqualified stock options if certain requirements are met:

a. The exercise price to purchase stock under the option is never less than the fair market value of the underlying stock on the date the option was granted;

b. The number of shares subject to the option is fixed on the date the option was originally granted;

c. The transfer or exercise of the option is subject to tax under the principles of IRC Section 83; and

d. The option does not include any feature for the deferral of compensation – such as providing that the stock will be issued more than 2-1/2 months after the close of the year in which the exercise occurs, or providing that the option holder has his taxes paid.

e. Common stock of the "service recipient" is used for the option, because of the concern that preferred stock could be a means of providing deferred compensation.

   (i) Use stock that is traded on an established securities market or, if none, the common stock with the highest aggregate value of any class of common stock.

   (ii) The stock cannot be subject to a mandatory repurchase restriction or a put or call right that is based on a measure other than fair market value.

f. ***Note***: If a discounted option is used, and it becomes subject to 409A, then the option can still avoid the 409A sanctions if it is exercised within 2-1/2 months after the end of the year in which the option vests. However, if this is not done, then it must only become exercisable in connection with an event that is considered a "permissible distribution event" under 409A, or else the exercise will trigger the 409A sanctions.

g. If you modify the option to extend the term later than 2-1/2 months after the expiration of the original term date or the end of the year, you may have 409A issues, especially if the price has changed.

4. <u>Stock Appreciation Rights (SARs).</u> The final regulations exempt SARS granted with respect to both privately-held and publicly-traded stock, provided that the following requirements are met:

   a. SAR compensation cannot be greater than the difference between the fair market value of the underlying stock on the date the SAR was granted and the fair market value of the stock on the date the SAR is exercised;

   b. The number of shares subject to the SAR must be fixed on or before the date the SAR was granted;

c. The exercise price may never be less than the fair market value of the underlying stock on the date the SAR was granted;

d. The SAR cannot include any other feature for the deferral of compensation—meaning that the appreciation must be paid within 2-1/2 months after the close of the year in which the exercise occurs; and

e. Common stock of the "service recipient" is used for the SAR. If the service recipient is publicly traded, then the publicly traded stock must be used.

f. ***Note:*** If a SAR is subject to 409A, then it can avoid 409A sanctions if the exercise and payment are made within 2-1/2 months after the close of the year in which the SAR vests; otherwise, payment can only be made upon a permitted distribution event, such as a fixed date after exercise or on a separation from service.

5. <u>Restricted Stock.</u>

a. The transfer of restricted stock is not subject to 409A, regardless of whether a Section 83(b) election has been made to include the value of the restricted stock in income.

b. A legally binding right to receive stock at some future date would constitute deferred compensation unless the transfer occurs within 2-1/2 months after the close of the year in which the right vests.

c. Rights to dividends or other distributions that are *contingent* on the exercise of the stock right are considered to defer compensation, because they are viewed as effectively reducing or offsetting the exercise price of the option or SAR. Non-contingent, independent dividend or dividend-equivalent payments that are treated as a separate plan do not constitute deferred compensation.

6. <u>Restricted Stock Units, Performance Shares & Phantom Stock.</u>

a. The grant of restricted stock units that are payable in restricted stock (or their cash equivalent) upon the satisfaction of performance criteria, longevity or some combination of the two, will generally be considered deferred compensation because the "promise" to make the grant or payment is unsecured.

b. If payment is made at the time of vesting—when the performance or longevity requirements are met—or within 2-1/2 months after the end of the year in which the vesting occurs, in order to take advantage of the short-term deferral rule, then 409A would not apply.

c. If payment is made beyond the short-term deferral period, then 409A will apply, which will mean that the distribution provisions must be "hard wired" into the grant agreement in order to avoid any 409A sanctions.

7. Valuation Issues.

a. If stock is publicly traded, then fair market value is based on the trading price. It is permissible to use the average selling price during a specified period within 30 days before and 30 days after the grant.

b. If stock is privately held, valuation must be determined by the reasonable application of a reasonable valuation method, based on the facts and circumstances. Factors to be taken into account include:

(i) The value of all assets –tangible and intangible.

(ii) The present value of future cash flow.

(iii) The value of comparable businesses.

(iv) The amount of any recent arm's length transactions involving the sale of the stock.

c. A control premium or discount for minority interests and/or lack of marketability.

d. The following valuation methods are presumed to be reasonable (provided the method is consistently used), although the IRS can overcome the presumption of reasonableness upon a showing that the valuation method was grossly unreasonable.

(i) An independent appraisal within 12 month of the relevant transaction.

(ii) A formula price – i.e., book value or a reasonable multiple of earnings—meeting certain requirements under IRC Section 83, which is used consistently.

(iii) For start up corporations (less than 10 years), a reasonable good faith written valuation that takes into account the factors discussed above; however, the stock cannot be subject to a put, call or other obligation other than a right of first refusal; the special rule does not apply if it is reasonably expected that there will be a change in control or IPO in the next 12 months; and the valuation must be performed by someone with significant knowledge or experience (insiders permitted).

8. Profits and Partnership Interests. Issuance of profits interests, partnership interests and options on partnership interests are treated the same as other equity-based compensation. The IRS has indicated that it will propose rules at a later date to address this issue.

9. Modifications.

a. Any modification of the terms of a stock right will generally be considered the grant of a new stock right; any exchanges or extensions may be treated as an additional deferral of compensation.

b. However, the substitution or assumption of outstanding stock rights in a corporate transaction should not create any deferred compensation problems, and should not be treated as the grant of a new stock right, under certain conditions described in the final regulations.

V. NEW RULES FOR DEFERRAL ELECTIONS.

A. Timing of Deferral Elections.

1. General Rule.

a. Elections to voluntarily defer compensation must be made before the start of the year in which services for the compensation are performed, even if the employee/service provider is not vested in the amount being deferred. (2008 elections for 2009 services.)

b. "Evergreen" elections are permitted—where election for one year remains in effect for the following year unless terminated or changed by the executive before December 31st, because elections become irrevocable on that date.

2. Special Rule for Mid-Year Awards.

   a. ***Example****:* If a participant already deferring salary into a nonqualified plan gets promoted mid-year and is now eligible for deferred bonuses.

   b. 30-day rule with 12-month condition: Participants who are given mid-year awards can make elections within 30 days after they are given a legally binding right to the compensation, but that deferred compensation must be subject to a condition of forfeiture regarding continued service for a period of 12 months.

   c. This ensures that the initial deferral is made at least 12 months before the forfeiture condition can lapse.

   d. ***Note***: For purposes of determining whether an individual can take advantage of the special rules that apply to mid-year awards, the plan aggregation rules will apply. Thus, a service provider that is already participating in a plan of the same type may be precluded from making a mid-year initial deferral election.

3. Special Rule for Newly-Eligible Participants.

   a. If someone becomes newly eligible, he can make an election within 30 days after the date he becomes eligible, but only with respect to compensation for services performed after the election. (***Note***: For purposes of determining whether a person is "newly eligible" and therefore eligible for the 30-day rule, the plan aggregation rules apply. Thus, if a service provider already participates in another deferred compensation plan of the same type, he would not be considered "newly eligible".)

   b. For compensation that is earned based on a specific performance period, such as annual bonus, the election will apply to a percentage of compensation, based on the number of days remaining in the performance period after the election, compared to the total number of days in the performance period.

4. Special Rule for Short-Term Deferrals: Compensation payable within 2-1/2 months after the end of the year in which it is vested may be deferred as long as the deferral election is made at least 12 months prior to the vesting date and the payment is delayed for a period of at least 5 years after the vesting date (although payment can be made earlier in the event of a change of control).

5. <u>Special Rule for Performance-Based Compensation</u>.

a. Election for "performance-based compensation" must be made 6 months prior to the end of the period over which performance is measured—for instance, by June 30th 2008 for the bonus year ending 12/31/08.

b. "Performance-based compensation" is compensation, the payment or amount of which is contingent on the satisfaction of pre-established organizational or individual performance criteria, and which is not readily ascertainable at the time of the election. It generally is not compensation payable for a period of service that is equal to the value of a predetermined number of shares of stock and is variable only to the extent that the value of such shares appreciates or depreciates.

c. *First prong*: Performance criteria.

(i) Subjective performance criteria are permissible, provided that:

(I) The subjective performance criteria relate to (A) the performance of the executive, (B) the performance of a group of service providers that includes the executive, or (C) the performance of a business unit for which the executive provides services; and

(II) The determination that the subjective performance criteria have been met is not made by the executive, a member of the executive's family, a person under the effective control of the executive, or a person over whose compensation the executive has any control.

(ii) The performance criteria can be established any time within the first 90 days of the performance period, provided that the outcome is not substantially certain at the time the criteria are established.

d. *Second prong*: Payment of compensation must be contingent on satisfying the performance criteria.

(i) Amount must not be readily ascertainable at the time of the election.

(ii) The amount of compensation must not be substantially certain to be paid, regardless of the level of performance.

6. Other special rules provided in the regulations address commissions (which are treated as being paid in the year in which the customer makes payment for the goods or services giving rise to the commission); fiscal year compensation; payments made on a final payroll that spans fiscal years, etc.

B. Content of Elections. The elections must specify:

1. The amount of compensation being deferred.

2. The timing of when the deferred compensation will ultimately be paid out.

3. The form of how the deferred compensation will ultimately be paid out.

C. Irrevocability of Elections.

1. General Rule: Amount of compensation being deferred must be irrevocable.

2. Exceptions:

a. A plan can permit changes in filed elections prior to the last day it becomes irrevocable (i.e., a deferral election filed before 12/31 can be changed prior to 12/31, the date on which it becomes irrevocable).

b. Cancellation of a deferral election mid-year (and for the remainder of the year) is permissible if the participant has received a distribution from the nonqualified plan due to an unforeseeable emergency, or from a 401(k) plan due to hardship.

c. Adjustments in nonqualified plan deferral elections that occur automatically, based on the deferral elections made in a qualified 401(k) plan, are permitted and do not violate the rule against irrevocable elections. (However, as discussed below, there are other limitations that apply to qualified and nonqualified plans that are linked.)

VI. NEW RULES FOR DISTRIBUTIONS OF DEFERRED COMPENSATION.

A. Irrevocability of Elections.

1. Must be in writing at the time the compensation is initially deferred.

2. Must be irrevocable regarding the *time* and *form* of payment.

3. Limitations on subsequent elections or changes in elections of deferred compensation (or substitutions of one type of deferred compensation payment for another, which will be considered to be like a subsequent election or change):

    a. Cannot take effect for at least 12 months.

    b. Be made at least 12 months before the first payment is due.

    c. Must defer payments for at least 5 years (or upon death, disability, or unforeseeable emergency).

    The rationale for this rule is to provide employees with flexibility regarding distributions, but at the same time subject the employee to an additional 5 years of risk as the "toll charge" for making the change.

4. Special rules apply to permit changes to or from an annuity or installment payment election, or from one type of annuity to another.

    a. A change in one type of annuity to another is not treated as a change in the form of payment as long as the change is made before payments begin. (For example, a change from a joint and survivor annuity to a life annuity).

    b. An annuity form of payment, and installment payments, are treated as a single payment that are made on the first installment—thereby allowing a change to another form of payment, such as lump sums, as long as the change is made at least 12 months before the annuity or installment starting date and the payment is deferred for at least 5 years.

5. Elections cannot be linked to qualified plan elections; rather, there must be a separate payment election for the nonqualified deferred compensation plan.

6. Other delays permitted under certain circumstances.

   a. Types of delays permitted by the final regulations:

      (i) Where company expects a limitation or elimination of its deduction for the payment because it would be subject to the limitations on compensation payable to executives of publicly-held companies under IRC Section 162(m).

      (ii) Where company expects that making the payment would violate a loan covenant or similar contract and that violation would jeopardize the ability of the company to continue as a going concern.

      (iii) Where company expects that payment would violate Federal securities laws or other applicable laws.

   b. Generally, delay is only permitted until the 1st calendar year following the expiration of the condition that caused the delay; then distributions must be made.

   c. ***Caution***: Plan amendments to add these delay provisions cannot take effect for at least 12 months after adoption.

B. Permissible Times of Payment That Can Be Elected.

Distributions of deferred compensation may not be made except in connection with one of the following events (although different payment dates can be designated for different payment events):

1. A Fixed Date, or According to a Fixed Schedule.

   a. This means that both the *amount* and the *date* of payment must be objectively determinable at the time the amount is deferred, based upon a date, year, or fixed schedule. As a general rule, the occurrence of a specified event, such as the closing of an IPO, will *not* be sufficient in order to have the date be objectively determinable at the time of deferral.

   b. There cannot be any contingencies upon occurrence of events that can be manipulated.

   c. Idea is to “hard wire” into plan documents exactly when and under what circumstances deferred compensation will be paid.

d. *Amount* of payment can be fixed or determined under a nondiscriminatory formula—e.g., 50% of account balance.

(i) The final regulations clarify that a plan provision that reduces a schedule of periodic payments on a dollar-by-dollar basis, by the amount of Social Security benefit payments, or by disability payments or similar reductions, can still meet the requirements of providing a nondiscretionary and objective formula for determining the amount of deferred compensation that is payable.

(ii) From a practical perspective, this requirement can create problems for taxable reimbursement, where the amount is not known at the time the right to payment vests and is not known until after the short-term deferral period has passed.

(iii) ***Planning tip***: Design the deferred compensation plan or agreement to provide the executive with a specified dollar amount, regardless of whether the expense is actually incurred.

e. *Date* of payment must be specified or objectively determined.

(i) A plan can specify the calendar year in which payment will be made, without specifying a particular date. (Payment is deemed to be January 1st).

(ii) A payment will be treated as being made on the specified payment date as long as it is made on that date, or on a later date within the same calendar year (or, if later, by the 15th day of the 3rd month following the date specified under the arrangement).

(iii) A payment will also be treated as being made on the specified payment date—and not treated as an impermissible accelerated payment—if it is made no earlier than 30 days before the designated payment date and the service provider cannot designate or manipulate the taxable year of the payment.

(iv) Payments made upon the occurrence of a specified event are not sufficiently specific about the time; however, payments made on a specified date, or according to a specified payment schedule, following the occurrence of a vesting event are permitted—such as 3 years after an IPO—even though the payment is tied to an event.

(iv) If calculation of the amount of the payment is not administratively practicable due to events beyond the control of the executive; if company does not have sufficient funds to make the payment without jeopardizing the company's solvency; or if there is a dispute about the payments or the company's refusal to make the payments, the regulations provide that the payment will be treated as being made on the payment date specified as long as it is made during the first calendar year in which the funds the situation is resolved.

f. This provision can also be used to enable payments to an individual service provider that are tied to a schedule of payments received by the service recipient.

(i) Payments tied to the service recipient's schedule satisfy the fixed payment schedule requirement as long as the following certain standards are met, which are intended to ensure that there is no manipulation or acceleration of payments:

(I) Payments to the service recipient arise from bona fide and routine transactions in the ordinary course of its business, such as routine sales;

(II) The service provider does not have effective control over the service recipient, the person from whom the amounts are due, or the collection of those amounts; and

(III) The payment schedule provides an objective, nondiscretionary method of identifying the payments to the service recipient and to the service provider.

(ii) "Earn out" payments involved with the sale of a company, which are calculated by reference to the value of the company stock are permissible, as long as they are paid no later than 5 years after the date of the change in control involved with the transaction, and certain other conditions are met.

2. <u>Separation from Service:</u> Generally, a termination of employment.

   a. Facts and circumstances determination, based on level of services that is continued to be provided. (The IRS is concerned about situations that allow employees to separate in order to receive a distribution but continue to provide significant services through consulting or other agreements).

      (i) A separation from service occurs when an employee terminates employment with an employer (including all members of the employer's controlled group within the meaning of IRC Section 414).

      (ii) The "same desk" rule from 401(k) context is not adopted.

      (iii) An anti-abuse rule in the final regulations provides that consulting and employment agreements will not be permitted to allow for the extension of deferrals where the executive is not really performing any "significant services". Likewise, if an employee continues to perform "significant services", a separation from service will not be deemed to have occurred.

      (iv) Threshold for "significant services": If services are rendered at an annual rate equal to no more than 20% of the average level of services provided, based on a 3 year rolling average, and annual remuneration for the services is at least 20% of the average during the immediately preceding three full calendar years. The final regulations contain a rebuttable presumption that a termination has occurred if services are less than 20%, but a separation from service will be deemed not to have occurred if services are 50% or greater. The regulations do not have any presumptions for service between 20-50%.

      (v) For non-employees, services will be considered "significant" if (I) the services rendered are equal to 50% or more of the services rendered, based on a rolling 3 year average, and (II) annual remuneration for the services is 50% or more of the average annual compensation during the 3 year averaging period.

   b. Temporary leaves of absence will not be considered a separation from service if less than 6 months in duration, or if there is statutory or contractual guarantee of reemployment, such as under

USERRA or FMLA. Other special rules in the final regulations apply to other leaves of absence.

c. For asset purchase deals, the seller and buyer can specify whether the service provider providing services to the seller immediately before the sale, and to the buyer immediately after the sale, has experienced a separation from service; however, all similarly situated individuals must be treated consistently, and the agreed-upon treatment must be specified in writing no later than the closing on the asset purchase transaction.

d. ***Planning tip:*** Many plans/amendments are moving towards this concept rather than traditional concepts of "retirement" and "termination of employment."

3. <u>Disability.</u>

a. Statutory definition: Executive has a medically determinable physical or mental impairment that can be expected to result in death or last for at least 12 months, and is either unable to engage in any sustained activity or is receiving income replacement benefits for at least 3 months under a company plan.

b. Safe harbor: If the executive is determined to be disabled by the Social Security Administration, or under the terms of any disability insurance program which incorporates these definitions of disability.

4. <u>Death.</u>

5. <u>Change in Control.</u>

a. Must relate to company for whom the executive was providing services at the time of the change in control event; the company that is liable for the payment of the deferred compensation; or the company that is a majority shareholder of either of the above.

b. Change in more than 50% ownership of the total fair market value or total voting power of the stock.

c. Change in effective control:

(i) Any person acquires ownership of stock with at least 30% or more of the total voting power of the stock of the company; or

(ii) A majority of members of the company's board is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the incumbent board.

c. Change in ownership of at least 40% of the gross fair market value of assets of the company immediately prior to the acquisition.

d. Transfer to related persons will not cause a change in control event.

e. Other change in control definitions can be used for plan purposes other than distribution, such as vesting.

f. Payments of certain transaction-based compensation related to a change in control event (such as earn-out payments) can be treated as being paid at a designated date on a payment schedule that complies with 409A, if the transaction-based compensation is paid on the same schedule, and under the same terms and conditions that apply to shareholders generally, and are paid within 5 years of the change in control event.

g. The plan sponsor has the right to terminate the plan and pay out the deferred compensation within 12 months of a change of control—this is an exception to the anti-acceleration provisions.

6. <u>Unforeseeable Emergencies.</u>

a. Severe financial hardships arising from illness or accident of the executive, his spouse, or dependent.

b. Casualty loss.

c. Similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

d. Unlike hardship distributions from a 401(k) plan, distributions for an unforeseeable emergency may be made without considering whether the emergency could be relieved through other means (*i.e.*, insurance, liquidating assets or loans from qualified plans).

e. Amount of distribution must be limited to the amount reasonably necessary to satisfy the emergency need (which can include amount necessary to pay any taxes anticipated to result from the distributions).

f. ***Examples*** provided in the regulations:

(i) Examples of expenses that WOULD constitute unforeseeable emergencies:

(I) Imminent foreclosure or eviction from the executive's primary residence.

(II) Payment of medical expenses, including deductibles and prescription drugs.

(III) Payment of funeral expenses of a spouse or dependent.

(ii) Expenses that would NOT constitute unforeseeable emergencies:

(I) Purchase of a home.

(II) Payment of college tuition.

C. <u>Limited Acceleration Rules.</u>

1. General rule: A deferred compensation arrangement subject to 409A cannot permit acceleration of the time or schedule of any payment, whether at the employee's or employer's discretion.

2. No "haircuts" (reductions in benefits) in order to access funds at an earlier time are permitted.

3. Distribution elections can be designed to permit limited acceleration among permissible (intervening) events—such as upon the earlier or later of two permissible events—but these changes cannot be made to amounts previously deferred without running potentially afoul of the limitation on acceleration of payments, or afoul of restrictions that apply to changes in the time and form of payment.

Example: Elect installments over 5 years upon separation from service, but payment in a lump sum if die first.

4. Acceleration permitted for payments required to be made under a domestic relations order.

5. Acceleration permitted for payments necessary to comply with a divestiture for a conflict of interest.

6. Acceleration permitted for de minimis payments of less than the limit on annual 401(k) deferrals ($15,500 for 2008), provided that is the full payment of the individual's interest.

7. Acceleration permitted upon termination of the plan in limited circumstances (important planning tip for M&A deals):

   a. Corporate dissolution or bankruptcy.

   b. Within 30 days before, or 12 months following a change of control, but only if (i) all similar arrangements are terminated, and (ii) all amounts deferred are paid out within 12 months of the date of termination.

   c. By the company's action, but only if (i) the termination and liquidation of the plan does not occur proximate to a downturn in the financial health of the service recipient; (ii) all arrangements are terminated; (iii) no other payments are made within 12 months of the termination; (iv) all payments are made within 24 months; and (v) the company does not adopt a new arrangement any time within 3 years.

D. <u>Six-Month Delay for Certain Key Employees Of Public Companies Upon Separation.</u>

1. Only payments upon separation from service are affected.

2. Determination of which "key employees" of a public company are affected.

   a. "Top heavy" definition (determined on controlled group basis):

      (i) One of top 50 officers earning more than $150,000.

      (ii) 5% owner.

      (iii) 1% owner earning more than $150,000.

   b. Company gets to select a specified employee identification date (*i.e.*, December 31st, unless another date is designated), and that date must be used for all nonqualified deferred compensation plans and must be specified in each plan document. Then, anyone who is a key employee on that date is subject to the 6-month delay for a 12-month period beginning 4 months after the identification date.

Example: If the specified employee identification date is December 31, 2007, anyone identified as a key employee on that date will be subject to the 6-month delay if they separate from service and would otherwise be entitled to receive payments during the period from April 1, 2008 through March 31, 2009.

c. Special rules apply in the context of mergers, acquisitions and spinoffs, especially where one party is publicly traded and the other is not.

3. The plan or agreement must specify, in writing, how the delay in payments will be handled.

a. The delayed payments can be paid in a lump sum after the expiration of the 6 month period; or

b. The agreement could provide that each scheduled payment will be delayed 6 months.

c. How the delay is handled can be changed at any time, but the change cannot be effective for a period of 12 months.

d. The 6 month delay rules must be written into the plan document before a service provider becomes a specified employee who is subject to the restrictions delaying payment.

VII. LIMITS ON LINKED OR WRAPAROUND PLANS.

A. Contribution Elections.

1. The regulations clarify that the rule regarding irrevocable elections of amounts deferred are not violated if amounts elected to be deferred in nonqualified plan increase or decrease depending on an election made in an underlying plan.

2. Safe harbor designs sanctioned by the regulations.

a. Amount of increase in additional deferrals under a nonqualified plan that is tied to a 401(k) plan cannot exceed the IRS limit on elective deferrals ($15,500 for 2008); same limit applies to additional matching contributions made under a nonqualified plan.

b. Spillovers: Nonqualified plan can be designed to provide that as long as the executive specifies a percentage of pay that will be contributed to the nonqualified deferred compensation plan at the end of the year, within a reasonably administrative period of time after the end of the year, an amount is transferred from the nonqualified plan to the underlying 401(k) plan up the IRS limits on elective deferrals ($15,500 for 2008), with the balance remaining in the nonqualified plan, as long as the spillover amount does not exceed the full amount that could have been provided under the qualified plan, absent any plan or tax code limits . This is not deemed to be an impermissible acceleration of payments.

B. Distribution Elections.

1. Time and form of payment elections should no longer be linked.

2. Safe harbors.

VIII. LIMITATIONS ON RABBI TRUSTS.

A. Traditional rabbi trusts continue to be permissible.

B. Offshore rabbi trusts are problematic.

C. “Springing” rabbi trusts, which come into existence depending upon the employer’s financial health, are problematic. Future guidance will address this.

D. Under the Pension Protection Act of 2006, companies will not be able to fund deferred compensation arrangements for certain specified employees (employees of a publicly traded company, who is subject to IRC Section 162(m) limits on compensation or Section 16 insiders) if they file for bankruptcy, if their defined benefit plan is under funded below certain target thresholds, or if their defined benefit is terminated in an involuntary or distress termination.

IX. REPORTING OBLIGATIONS.

A. The amount of deferrals under a nonqualified plan must be reported in Box 12 of a W-2 , using Code "Y" (for an employee) or in Box 15a of a 1099-MISC (for a nonemployee). *This requirement has been suspended for 2007.*

B. The amount of deferred compensation that is includible in an individual's income under 409A must be included in wages or income also specifically in Box 12 of a W-2, using Code "Z" (for an employee), or in Box 15(b) of a 1099-MISC (for a nonemployee). This requirement has *not* been suspended.

X. LIMITED CORRECTION PROGRAM.

A. The IRS has established a limited correction program for unintentional operational failures, which is available to correct the following:

1. Operational failures that occurred during the year of correction, such as (a) mistakes in carrying out deferral elections; (b) erroneous payments of amounts to key employees, of amounts prior to the time that they were scheduled to be paid, or of amounts that should have been deferred; and (c) unintended errors resulting in the exercise price of a stock option or SAR being less than the fair market value of the underlying stock on the date of the grant.

2. Operational failures, such as impermissibly accelerated payments or failure to make payments, which occur before 2010, involve only limited amounts (up to the limit on annual deferrals to a 401(k) plan, which is set at $15,500 for 2008), and are corrected within 2 years.

B. The program does not provide any correction for plan documentation failures.

C. The IRS anticipates broadening the correction program.

XI. PLANNING OPPORTUNITIES FOR 2008.

A. Ability to change elections regarding *timing* and *form* of payments has been, extended through December 31, 2008, provided that the change would not affect payments due to be made in the year of the change or accelerate and cause amounts to be payable in the year of the change.

B. Opportunity to substitute nondiscounted stock options and SARS (not subject to 409A) for discounted ones (subject to 409A) has generally been extended through December 31, 2008.

C. Deferral elections for 2009 need to be made by December 31, 2008.

D. Payment elections regarding the *timing* and *form* of payments from nonqualified plans that are linked to qualified plans can remain in place through December 31, 2008.

XII. COMPLIANCE CHECKLIST.

A. Inventory all plans subject to 409A (comprehensive review of all plans and agreements). Be sure to include:

√ Voluntary deferred compensation plans or arrangements
√ Supplemental retirement or "wraparound" plans or arrangements
√ Excess benefit plans
√ Employment agreements; contractor agreements; directors' fee agreements or policies
√ Commission programs or plans
√ Short and long-term incentive plans
√ Bonus plans or agreements
√ Severance plans or policies
√ Change of control & retention plans, policies or agreements
√ Policies or contractual terms for reimbursement or coverage of expenses and benefits post-termination
√ Stock option plans
√ Restricted stock plans
√ Other stock or equity rights programs, including SARs, RSUs, phantom stock, etc.

B. Determine which arrangements are subject to 409A, and which are exempt.

1. Determine whether any arrangements have "grandfathered" benefits – amounts earned and vested prior to January 1, 2005 that have not been subsequently modified – because these need to be separately accounted for.

2. Determine which arrangements may be exempt from 409A – short-term deferral terms; severance arrangements that satisfy the safe harbor; and stock options and other equity issued at full value.

C. Determine what changes need to be made. Examples include:

√ New definitions of "separation from service"; "change of control"; "disability"; "unforeseeable emergency"; etc.
√ New provisions for deferral elections
√ New distribution terms
√ Six-month delay for specified employees
√ Elimination of employer discretion
√ Elimination of any haircuts
√ New provisions for plan termination
√ Rabbi trust provisions
√ Decoupling of payment terms between qualified and nonqualified plans that are otherwise linked

D. Operational good faith compliance through 12/31/08 (requires updated election forms; payment elections, and participant communications). Compliance with final regulations will constitute good faith compliance.

E. Determine whether any payment elections should be changed by 12/31/08, and whether any discounted options or SARs should be substituted with non-discounted (full value) options or SARs.

F. Prepare all necessary plan amendments by 12/31/08—including review and amendments of any trust and service provider agreements.

G. Make 2009 deferral elections by 12/31/08.

H. Prepare "top hat" plan filing with DOL and 8-K filing with SEC, if appropriate.

TOP 5 THINGS THAT YOU NEED TO KNOW ABOUT THE NEW EXECUTIVE COMPENSATION RULES

√ **Amendments Are Coming!**

All plans or agreements that are considered "deferred compensation plans" under the new law need to be operated in compliance with new Section 409A during 2008, and be updated in writing by **12/31/08** to comply with Section 409A.

√ **The New Rules Are Very Broad And Cover Arrangements You *Never* Thought Were Executive Compensation**

- Traditional deferred compensation plans
- Employment agreements: deferred payments, fringe reimbursements, etc.
- Certain bonus, incentive programs
- Certain features of termination or separation agreements
- Certain severance policies or plans
- SARs, RSUs, and other phantom or synthetic equity programs
- Certain payments under buy-sell or partnership arrangements
- Discounted stock options

√ **Key Changes Under The New Law**

- Deferral elections cannot be changed after they are made
- Restrictive rules about payments (distributions) - must be specified upfront; generally cannot be changed or accelerated; no employee or employer discretion permitted
- Payments can only be made under 1 of 6 alternative circumstances:
  - □ On a specified date or schedule
  - □ At separation from service
  - □ Disability
  - □ Death
  - □ Change in control
  - □ Unforeseeable emergencies
- Payments to key employees in publicly traded companies must be delayed for 6 months if due to separation from service
- Limits on certain rabbi trust funding arrangements

√ **What Is At Risk If Changes Are Not Made?**

Immediate taxation to the executive = regular income taxes ***plus*** 20% excise tax ***plus*** 2nd tier excise tax equal to the IRS underpayment rate + 1%

√ **What Should Be Done Now?**

- Talk to clients and raise the issues
- Inventory plans and arrangements and identify what is (and what is not) subject to 409A
- Identify what changes are necessary by 12/31/08 and what steps must be taken now to ensure operational compliance
- Obtain approval by board/compensation committee; make all required changes