MAYER BROWN ROWE & MAW

Executive Compensation and Benefits Update

How the Final Section 409A Deferred Compensation Rules Affect Employer Plans

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On April 10, 2007, the IRS issued final regulations (the "Final Regulations") covering the nonqualified deferred compensation rules imposed by section 409A of the Internal Revenue Code. The Final Regulations differ in many respects from the proposed regulations published on October 4, 2005 (the "Proposed Regulations"). This memorandum summarizes key aspects of the Final Regulations and highlights some of the significant effects of the guidance on different types of plans. This memorandum is a summary of complex rules and does not address all of the issues raised by the Final Regulations.

Generally, section 409A applies to amounts deferred on or after January 1, 2005. The Final Regulations require that all plans that are subject to section 409A and that provide for payments after December 31, 2007 must be amended to conform to the requirements of the Final Regulations. For the period between January 1, 2005, and December 31, 2007, plan operation may either satisfy the requirements of prior IRS guidance, as set forth in IRS Notice 2006-79, or may satisfy the requirements of the Final Regulations. The Final Regulations require that, no later than December 31, 2007, plan documents be revised to comply with the rules as of January 1, 2008. While the Final Regulations do not require employers to amend plan documents to bring them into compliance with the rules for periods before January 1, 2008, it may be desirable to do so, for example, to help ensure consistent plan administration or to demonstrate compliance for the period since January 1, 2005. Where an employee begins receiving payments before January 1, 2008, or where all events necessary to receive payments occur before January 1, 2008, and the payment is consistent with the guidance issued before the Final Regulations, payments may be made (or continued) whether or not such payments otherwise would be permitted under the Final Regulations.

General Rules

Employees, Independent Contractors, and Plans

Section 409A generally applies to payments from "service recipients" to "service providers." (As discussed below, the rules also apply to partnerships, subject to the exclusions provided by prior guidance.) Although a "service provider" can be an employee, director or independent contractor, for ease of reference this memorandum uses the term "employee" to refer to all service providers subject to section 409A, and the term "employer" to cover all service recipients. Similarly, although the rules apply to any deferral arrangement, whether by individual contract or otherwise, this memorandum generally uses the term "plan" to refer to any such arrangements covered by the rules.

Coverage

General. With limited exceptions, section 409A applies to all arrangements (including individual agreements) that provide for the deferral of compensation. An arrangement will generally be treated as providing for a deferral of compensation if the compensation is or may be paid after the year in which the employee obtains a right to it. The determination of whether an arrangement defers compensation is generally made without regard to whether the employee's right to compensation is vested at the time the right arises. (However, see the discussion of short-term deferrals, below.) Qualified retirement plans and many types of welfare plans are excepted but, as discussed below, there is no categorical exception for severance pay plans. Nontaxable benefits also are not subject to the deferred compensation rules, unless the employee has the right to exchange them for taxable benefits.

Short-Term Deferral Exception.

Section 409A does not apply to "short-term deferrals," which are generally defined as amounts that are paid during

the year in which they are no longer subject to a substantial risk of forfeiture (i.e., the time at which they are "vested"), or within $2^1/_2$ months after the end of that year. For purposes of the section 409A rules, an employee is treated as vested in an amount at the time he or she has a nonforfeitable right to payment of the amount that is not conditioned on either the performance of substantial future services by any person or the occurrence of a condition related to the performance of services or the employer's business activities or organizational goals, and the risk of forfeiture is substantial. Conditioning receipt of the amount upon the employee refraining from providing services, refraining from entering into competition, or releasing claims against the employer, will not constitute substantial risks of forfeiture for this purpose.

The availability of the short-term deferral exception generally does not require that the plan specify the time of payment or even that the plan be written. However, if payments are not made within the 2-1/2 month deadline, the existence of a written plan specifying a payment date within the short-term deferral period would allow the arrangement to be treated as a deferred compensation plan that satisfies the requirements of section 409A, provided that the payment is made at any time during the year following the year in which vesting occurs.

The Final Regulations provide that a payment can qualify as a short-term deferral even if payment is made beyond the $2^1/_2$ month deadline, under the following circumstances:

- It is administratively impracticable to make the payment within the deadline and such impracticality was unforeseeable at the time the right arose.
- Payment within the deadline would jeopardize the ability of the employer (and its affiliates) to continue as a going concern.
- The payment is delayed to avoid loss of deductibility under the $1 million limit of section 162(m) and the application of the limit to the payment was not reasonably foreseeable.

If a plan provides that payment could occur on more than one date, the short-term deferral deadline must be satisfied as of the last day on which payment could be made, regardless of whether payment in fact is made on a prior date. The regulations give the example of a plan providing for payment of benefits on separation from service. Payment of those benefits would not satisfy the short-term deferral exception because a separation from service, and the resulting benefit payment, could occur more than $2^1/_2$ months after the end of the year in which the benefits become vested. The example states that the exemption would not be available even if, in fact, separation from service occurs, and the benefits are distributed, before the $2^1/_2$ month deadline.

Initial Deferral Election

If an employee is permitted to elect whether compensation will be deferred, the employee's deferral election must be made before the calendar year in which the services are performed, subject to exceptions. The deadline for filing the employee election as to time and form of payment of compensation is generally the same as the deadline for filing the deferral election for that compensation. Also, if the employer determines the time and form of payment, the deadline for establishing the time and form of payment is generally the same as the deadline for employee elections as to time and form of payment. Exceptions to this deferral election timing include the following:

- *Fiscal Years.* Deferral elections for compensation that relate solely to services performed in a non-calendar fiscal year must be made before the first day of that fiscal year.
- *Performance-Based Compensation.* As discussed under "Bonus Arrangements," below, it may be possible for an employee's deferral election to be made as late as six months before the end of the performance period if the compensation satisfies the requirements for performance-based compensation and the employee is employed continuously by the employer from the date on which the performance targets are established (or, if later, from the beginning of the performance period) through the date of the deferral election.
- *Initial Participation.* When an employee first becomes eligible to participate in a deferred compensation plan, either because the plan is newly established or because the employee first becomes eligible to participate in an existing plan, and provided that the employee is not eligible to participate in other plans of the employer or its affiliates of the same type, the employee may make an election to defer amounts under the plan, and make an election of the time and form of payment, not later than the 30th day after becoming eligible for the plan, but only for amounts earned after the election is made. This initial eligibility deferral election rule is also available in the case of an employee who has not been an

active participant in the plan for at least 24 months (e.g., due to termination of employment or transfer to an ineligible position followed by rehire or transfer back to an eligible position).

- *Election 30 Days after Grant.* Even if an employee is participating in other similar plans, a deferral election may be made by the employee not later than the 30th day after the award is granted, provided that the election is made at least 12 months before the date on which the award could vest. The Final Regulations provide a limited exception to this rule for vesting that occurs before the end of the 12-month period by reason of death, disability, or change in control (but not for other reasons, such as retirement).

- *Separation Pay.* As described under "Separation Arrangements," below, the Final Regulations provide that, for separation pay negotiated at the time of a separation from service (whether voluntary or involuntary), when the employee had no prior right to the separation pay, the decision as to the time and form of payment may be made up to the time the employer and the employee enter into a binding agreement providing for such separation pay.

- *Special Rule for Short-Term Deferrals.* In the case of an amount that, in the absence of a deferral election, would be treated as a short-term deferral, a deferral election may be made at least 12 months before the scheduled payment date provided that payment is deferred at least five years from the date it would otherwise have been paid.

Deadline for Selection of Time and Form of Payment

- *Requirement for Pre-Established Date.* For a plan that permits an employee to electively defer compensation, the time and form of payments attributable to the election must be irrevocably established not later than the deadline for filing the deferral election, as described above. It appears that because a deferral election must be irrevocable, and the rules generally treat all companies in a controlled group as a single entity, a transfer of an employee from one company to another company in the same controlled group during a calendar year could not result in a revocation of a deferral election for the remainder of that year.

- Requirement for Nonelective Plans. For plans that do not permit the employee to elect the time or form of payment, the deadline for designating the time and form of payment imposed by the Proposed Regulations was, under many circumstances, earlier than the deadline for employee elections as to time and form of payment under an elective arrangement. The Final Regulations modify the rules, so that the deadline for the employer to establish the time and form of payment for nonelective arrangements is the latest date that the employee would have been permitted to elect the time and form of payment if such election had been provided, or, the date the employer grants the right to the compensation.

- Initial Year in Nonelective Plan. The Final Regulations extend the deadline for electing the time and form of payment in the case of plans that solely provide benefits in excess of the limits applicable to qualified plans and do not require an employee deferral election as a condition of participation. For these plans, the participant's election as to the time and form of payment may be made not later than 30 days after the end of the first year in which the employee accrues a benefit under the plan.

Payment Schedules and Payment Triggers

- *Permitted Payment Triggers.* Payment may be made only on a specified calendar date or dates, or separation from service, death, disability (narrowly defined), unforeseeable emergency (very narrowly defined) or, in certain cases, a change in control (as discussed in "Business Transactions," below). A plan may provide that payments will be made on the earlier or the later of two or more events or dates, if each is otherwise a permissible event or date for triggering payment. The plan may also provide for a different form of payment (e.g., lump sum or installments) with respect to each type of event (as discussed below, under "Uniform Payment Method for Each Trigger").

- *Payments after Trigger.* Where payment is triggered by a separation from service, death, disability, unforeseeable emergency, or change in control, the plan may provide that payment will be made or commenced on the trigger date or pursuant to a schedule that is objectively determinable and nondiscretionary at the time the payment event occurs (e.g., payment will be made three years after separation from service). A payment schedule triggered by the vesting of the benefit pursuant to a

nondiscretionary vesting schedule will be treated as satisfying these requirements. A payment schedule based on the time at which the employer receives payments for transactions in the ordinary course of the employer's business will, under some circumstances, satisfy these requirements.

- *Time at Which Payment is Considered Made.* Payment will be considered to have been made on a scheduled date if made by the end of the calendar year that includes the scheduled payment date or, if later, and the employee is not permitted to designate the year of payment, within 2½ months after the scheduled payment date.

- *Uniform Payment Method for Each Trigger.* The Proposed Regulations required that, with respect to payments made by reason of a particular payment trigger (e.g., by reason of separation from service, by reason of death, or by reason of disability), the time and form of payment needed to be the same regardless of the other circumstances relating to the trigger. For example, it would generally have been impermissible for the time and form of payment to differ based on whether a separation from service was voluntary or involuntary. The Final Regulations retain this rule, but allow somewhat greater flexibility with respect to payments triggered by reason of separation from service, by permitting a plan to specify a different time and form of payment with respect to: (i) a separation from service within two years after a change in control (as that term is defined in the regulations), (ii) a separation from service before or after a specified date, or (iii) a separation from service before or after attaining a specified age or before or after a combination of attaining a specified age and completing a specified period of service.

- *Acceleration.* After the date of payment is established, an amendment of the arrangement providing for acceleration of the payment is not permitted except in very limited circumstances (such as for de minimis amounts or payment of certain tax and penalty obligations).

- *Subsequent Deferral.* Generally, after the time and form of payment are established, an election to defer payment to a later date is permitted only if the election is made at least one year prior to the scheduled payment date, and the election results in an additional deferral of at least five years.

- *Delay in Scheduled Payments.* The Final Regulations permit payments to be made later than the otherwise scheduled date under any of the following circumstances:

  - The delay is based on a pre-established, objective and nondiscretionary formula or method, where such formula or method is established by the deadline for designating the time and form of payment for such amounts.

  - The delay is necessary to avoid jeopardizing the ability of the employer (or its affiliates) to continue as a going concern, and a payment is made during the first year in which making the payment would not jeopardize such ability. This provision replaces the language in the Proposed Regulations permitting delays where current payment would violate a loan covenant. The language specifically addressing loan covenants is not included in the Final Regulations.

  - The employer intentionally or inadvertently delays payment, provided that the employee has not consented to the delay and makes reasonable efforts to collect.

  - Calculation of the payment by the scheduled date is not administratively practicable due to events beyond the control of the employee.

  - The delay is necessary to avoid a violation of securities law.

  - The delay would avoid the loss of a deduction for compensation over the $1 million limit on tax deductible compensation.

  - The delay is pursuant to a generally applicable earn-out provision in connection with the sale of a business.

- *Links to Qualified Plans.* As discussed in "Non-Account Balance Plans," below, the Final Regulations impose rules with respect to payments under a nonqualified plan that are different from the rules included in the Proposed Regulations.

Six-Month Payment Delay for Key Employees

Payments to a "key employee" of a public company that are triggered by reason of separation from service must be delayed for six months after the separation from service. A plan may provide that if the delayed amounts would otherwise be made in installments, the six-month delay can either

cause all payments to be moved back six months, or can cause all six months' worth of installments to be paid in the seventh month. Amounts that would otherwise constitute short-term deferrals can be made during the initial six-month period even if the total payment stream would extend beyond six months. Care will need to be taken in drafting arrangements to ensure that this treatment is available.

For larger companies, key employees generally include those officers who are the highest paid 10% of all employees, but not to exceed 50 officers. A plan may provide that the determination of key employee status will be based on a 12-month period specified by the plan and consistently applied. The determination of key employee status will apply for separations from service occurring through the 12-month period beginning on the first day of the fourth month after the year as to which the determination is made. The Final Regulations provide additional flexibility in determining the identity of key employees by permitting the employer to use any objectively determinable method that is reasonably designed to include all key employees, provided that no individual who would otherwise be treated as a key employee would be excluded under the method, and no more than 200 employees are included in the class at any time. The Final Regulations also provide more flexibility as to the determination of key employee status following a corporate transaction.

Plan Termination

The rules do not restrict an employer's ability to freeze a deferred compensation plan (that is, to cease future accrual of benefits). However, an employer is permitted to accelerate payment by reason of termination of a plan only under limited circumstances. Termination of a plan with payment of benefits will be permitted if: (i) the termination and payment is in accordance with the terms of the plan as in effect at the time the employee becomes covered by the arrangement and the payment is on account of one or more of the permitted payment triggers; (ii) the termination and payment occur within specified time periods in connection with the bankruptcy or liquidation of the employer; (iii) the termination and payment occur either within 30 days before, or 12 months after a change in control (as that term is defined in the regulations), as long as immediately after the change in control, all deferred compensation plans of the same type sponsored by the employer are terminated with respect to each employee affected by the change in control; or (iv) the termination is accompanied by the termination of all similar types of arrangements of the employer and its affiliates, and no termination payments are made either before the one-year anniversary or after the two-year anniversary of the termination, and no new plan of the same type is established covering persons who participated in the terminated plan until the three-year anniversary of the termination. In addition to the special change in control rules described above, other special rules apply to terminations of plans in connection with certain types of changes in control.

Requirements and Penalties

A deferred compensation arrangement must be reflected in a written document that complies with section 409A. The operation of the arrangement must also satisfy section 409A. The Final Regulations identify the provisions that must be included in the plan, and generally provide that the plan must include these terms not later than the occurrence of a deferral or accrual under the plan. The preamble to the Final Regulations indicates that the IRS does not intend to issue model amendments, and that general provisions that purport to nullify noncompliant plan terms will be disregarded.

Failure to satisfy the rules will generally not result in any adverse tax effect for the employer. However, an employer may be subject to tax penalties for failure to properly report non-conforming deferred compensation, and for failure to properly report and withhold on such compensation. Penalties resulting from failure to satisfy the rules apply to the employee, regardless of whether the failure results from action by the employee or by the employer. A failure to satisfy the rules results in the employee recognizing income for all vested amounts deferred under the plan as to which the failure occurred, and all other plans of the same type. The employee will also owe interest on all such amounts from the date those amounts originally became vested, and will be subject to a tax equal to 20% of the employee's benefits covered by the plan and all other plans of the same type. IRS guidance on calculation and application of the penalties is to be issued in the future.

As indicated above, in applying the penalty provisions (as well as certain other provisions of section 409A), plans of the same type must be aggregated. The Final Regulations provide for additional categories of types of plans, which generally has the effect of reducing the exposure resulting from a violation of the rules.

Partnerships

Notice 2005-1, issued by the IRS in December 2004, states that taxpayers are permitted to treat the issuance of a

partnership interest (including a profits interest), or an option to purchase a partnership interest, under the same principles that apply to the issuance of stock. The Final Regulations indicate that the IRS is continuing to study the application of section 409A to partnerships, and that until the issuance of further guidance, taxpayers may continue to rely on the Notice.

Application to Different Types of Benefits

Bonus Arrangements

A bonus arrangement will typically provide for payment of compensation based on the level of performance over a specified single-year or multi-year performance period. A bonus arrangement will be exempt from the section 409A deferred compensation rules as a short-term deferral if payment is made in the year in which vesting occurs or within 2½ months after the end of the year, subject to permissible delays under circumstances described under Short-Term Deferrals, above, and the arrangement does not permit later payment.

If the arrangement provides that all, or a portion of the payment will be made or completed on or after a date (or an event) that will or may occur after the above-described short-term deferral period, then, under the generally applicable rule, the time and form of payment of the deferral will need to be established before the year in which the performance period begins. However, if the arrangement satisfies the requirements for performance-based compensation, an employee election providing for the deferral may be made as late as six months prior to the end of the performance period. Amounts are treated as "performance-based compensation" if: (i) the performance period is at least 12 months; (ii) the payment is contingent on achievement of either subjective or objective performance criteria, which may be organizational or individual performance criteria; (iii) the criteria are established in writing while the outcome is substantially uncertain, but not later than 90 days after the beginning of the performance period; and (iv) the participant is employed by the employer starting on the beginning of the performance period or the date the performance criteria are established, whichever is later, and through the date on which the initial deferral election is made.

Account Balance Plans

Generally, an account balance plan provides for payment of amounts credited on the employee's behalf to one or more individual bookkeeping accounts maintained by the employer in the employee's name. Deferrals are credited to those accounts, and the account balances are adjusted for interest or earnings from time to time. Benefits under such an arrangement are based on the amount of the vested balances in the accounts at the time of payment. An account balance plan may be free-standing, or it may provide benefits that cannot be provided under a qualified retirement plan (such as a 401(k) plan) because of limits imposed on the qualified plans. Because such arrangements typically defer payment of benefits to a date that is several years after the employee becomes covered by the plan and becomes vested in plan benefits, the arrangements ordinarily will be subject to the deferred compensation rules.

Generally, in the case of an elective plan, the level of allocation to an employee's account for any year must be established by employee election before the beginning of the year. However, section 409A permits adjustments to the amounts credited to a nonqualified plan to the extent that these adjustments result from the application of limits on the qualified plan.

An account balance plan may permit employees to elect a different payment date, and a different form of payment, for each year's deferrals, provided that the elections conform to the general rules relating to deferral elections (e.g., that each election specifies a permissible payment date under the rules), as discussed in General Rules, above. However, while the use of different payment dates for amounts allocated for different years permits substantial flexibility for the employee, it ordinarily will also make the administration significantly more complex. It will not be permissible for a subsequent year's payment election to override a previous year's election with respect to amounts already deferred, subject to the exception noted above under "Deadline for Selection of Time and Form of Payment."

Non-Account Balance Plans

Generally, a non-account balance plan (e.g., a nonqualified defined benefit plan) provides for benefits determined pursuant to a formula (such as a final average pay multiplied by years of service multiplied by a specified percentage). Although a nonqualified defined benefit plan may be established as a free-standing arrangement, it is more commonly linked with an employer's qualified defined benefit plan, where the nonqualified plan providing benefits that cannot be provided under the qualified plan because of the limits imposed on such plans. Because such arrangements typically defer payment of benefits to a date that is several years

after the employee becomes covered by the plan and becomes vested in plan benefits, they ordinarily will be subject to the deferred compensation rules.

The Final Regulations follow the Proposed Regulations and provide that a change to the benefit amount in the nonqualified plan resulting directly from a change in limits under the qualified plan, resulting from an employee's decision to elect or not elect a subsidized benefit (e.g., an early retirement benefit) under the qualified plan, or resulting from certain other changes under the qualified plan, do not constitute impermissible changes to either a deferral election or a payment election under the nonqualified plan.

In the past, many nonqualified defined benefit plans with benefits linked to a formula under a qualified defined benefit plan have provided that payments from the nonqualified plan would be made in the same form and at the same time as payments from the qualified plan. Qualified plans are generally required to permit the employee to elect the time and form of payment shortly before the payment begins. Ordinarily, elections made at that time under a nonqualified deferred compensation plan would not satisfy section 409A. Under the Final Regulations, the timing of payment elections under a nonqualified plan cannot be linked to the payment election under a qualified plan. Such linked elections are permitted under the Proposed Regulations so long as the employee begins receiving payments before January 1, 2008, or where all events necessary to receive payments occur before January 1, 2008. This relief for linked elections is available only if the plan provided for linked elections as of October 3, 2004. The Final Regulations do, however, add some flexibility by permitting an employee or employer to choose any actuarially equivalent form of annuity at any time before payments begin.

Stock Awards

Many employees receive compensation that is based on the employer's (or an affiliate's) stock. The most common types of stock-based compensation awards are stock options, stock appreciation rights, restricted stock, performance stock, and stock units. The Final Regulations generally continue the treatment of stock-based compensation provided in the Proposed Regulations. These rules are discussed below.

Options and SARs

Stock options are rights to purchase a specified number of shares of stock at a specified price. Options may be structured as nonqualified options (NQOs) or incentive stock options (ISOs). Stock appreciation rights (SARs) are rights to receive the appreciation on a specified number of shares of stock.

ISOs are not subject to section 409A. The Final Regulations, like the Proposed Regulations, provide that NQOs and SARs may also be exempt from the rules. The exemption is available for NQOs and SARs on stock of both public and closely-held companies, and is available for SARs that are settled in cash and those that are settled in stock. The exemption is available only if:

- The exercise price can never be less than the fair market value of the stock at the time of grant. The Final Regulations clarify and liberalize certain requirements regarding the determination of fair market value for this purpose.
- The number of shares covered by the award is fixed at the grant date.
- The award is based on stock of the employer or on the stock of certain affiliated companies. The Final Regulations expanded the stock that may be used to generally include any class of common stock. The regulations also provide that such stock may be: (i) stock of the employer; (ii) stock of any company that directly or indirectly controls the employer though a chain of ownership and control of 50% of the stock; and (iii) if there is legitimate business criteria for the grant, stock of companies that have ownership of between 20% and 50% of the employer and its parent companies. However, the Final Regulations do not permit the use of stock of subsidiaries of the employer or corporations that are in a brother-sister relationship with the employer.

If an NQO or SAR fails to satisfy these requirements, it will be treated as deferred compensation and will, in almost all cases, fail to satisfy section 409A unless, among other things, there is a fixed exercise date.

A modification of the terms of a previously granted NQO or SAR or an extension of the exercise period will generally be treated as the grant of a new NQO or SAR award. However, the Final Regulations narrow the events that will constitute modifications, and provide that the extension of the exercise period beyond the period originally stated is not a modification, if the exercise period is not extended beyond the original term of the option or, if earlier, 10 years after the date of grant. This provision will allow employers to retain some

flexibility to provide for discretionary extensions of the exercise period at the time an employee terminates employment. Also, the acceleration of vesting of an NQO or SAR is not treated as a modification.

Restricted Stock and Performance Stock

Generally, awards of restricted stock and performance stock are delivered on or before the date of vesting. Vesting of these awards may be contingent on the completion of a specified number of years of service and/or achievement of specified performance goals. Stock that is delivered to the employee, and is treated as outstanding on the books and records of the employer at or before the time of vesting, will not be treated as deferred compensation subject to section 409A.

Stock Units (Phantom Stock)

Stock units (sometimes referred to as phantom stock) are shares of stock that are delivered after (or sometimes on) the date of vesting, where vesting is contingent on the completion of a specified number of years of service and/or achievement of specified performance goals. The date on which the shares are delivered may either be established by the employer or by the employee. Postponing delivery in this way will typically postpone the recognition of income until the date of delivery. Where stock delivery is made within 2½ months after the end of the year in which vesting occurs and the plan does not provide for a deferred payment, the awards will be exempt from section 409A as a short-term deferral. If the stock delivery is or may be deferred past that time, the awards will be subject to section 409A.

Generally, if the arrangement is subject to section 409A, the terms of the deferral and the fixed schedule for payment must be established before the year in which the grant occurs. However, for the grant of stock units, this deadline is often impractical, because the identity of the employees who will receive the awards, and the number of shares subject to the awards, are not known until after the beginning of the year in which the award is granted. In these circumstances, it will ordinarily be desirable to rely on one of the exceptions to the general deferral election rules. For example, it may be possible to rely on the exception for unvested awards. Under that exception, a deferral election can be made as late as 30 days after the date on which the award is granted, provided that the election is made at least 12 months before the date on which the award could vest (with an exception for vesting before the end of the 12-month period for death, disability, or change in control).

Dividends

In some cases, employees who receive options and SARs will be entitled to dividends on the stock prior to the vesting or exercise date (and, in some cases, regardless of whether the award is later forfeited). The Final Regulations provide that an arrangement to accumulate and pay dividend equivalents on shares subject to a stock option or SAR will not cause the award to be treated as deferred compensation, provided that payment of dividends is not contingent on exercise of the option or SAR, but the right to dividends must separately satisfy (or be exempt from) the deferred compensation rules. The Final Regulations also make clear that documentation of an arrangement providing for payment of dividends on options or SARs may be included in the stock plan, the individual stock rights agreement, or a separate agreement.

Separation Arrangements

Employers may provide departing employees with separation benefits. These benefits may be provided through a severance plan or a severance agreement, or under the terms of an employment or change in control agreement. Unless the severance arrangement is eligible for an exemption, described below, the time and form of payment of the severance benefits must be established when the employee is first covered by the severance plan or by the employment agreement or severance agreement. The Proposed Regulations provided an exemption from application of the rules for certain separation pay arrangements, and the Final Regulations liberalize the requirements for this exemption in several ways.

The following exemptions are available:

- *Collectively Bargained.* Separation payments will be exempt from section 409A if they are made to an employee covered by a collective bargaining agreement upon an involuntary termination, and the payments are made pursuant to the terms of that agreement.

- *Benefits Limited in Amount.* Separation payments will be exempt from section 409A if they satisfy the following requirements:

    - The amount of the separation payments is made on account of an involuntary termination (or pursuant to a window program). The Final Regulations expand the definition of "involuntary termination" to include certain resignations for Good Reason. The Final Regulations define "Good Reason" to be a material negative change in the employment

relationship (e.g., a material negative change to the duties performed, the conditions under which such duties are to be performed, or the compensation received). The Final Regulations also provide a safe harbor for a Good Reason termination, which requires that the employee provide notice of the Good Reason condition to the employer and an opportunity to cure, the termination must occur within two years following the time that the Good Reason condition arises, and the time and form of payment must be identical to the payments that would be made in the case of an involuntary termination. For purposes of the safe harbor, a Good Reason condition includes: (i) a material diminution in the employee's base compensation; (ii) a material diminution of the authority, duties, or responsibilities of the employee or the employee's supervisor; (iii) a material diminution in the budget subject to the employee's authority; (iv) a material change in geographic location at which services must be performed; or (v) another material breach of the employee's employment agreement by the company.

- The aggregate amount of the payments (other than certain reimbursement type payments discussed below) may not be more than two times the lesser of: (i) the employee's annual compensation for the calendar year prior to the year in which the termination occurs, or (ii) $225,000 for 2007, with cost of living adjustments after that. If an employee receives benefits that would satisfy the foregoing requirements except that they exceed the limits set forth above, the portion below the limit will be exempt.
- The payments must be completed not later than the end of the second calendar year following the calendar year in which the termination occurs.

As discussed above, a deferral election with respect to separation pay that is pursuant to a bona fide arm's-length negotiation at the time of a separation from service may be made until the employer and the employee enter into a binding agreement providing for such separation pay. This rule does not apply, however, to any separation pay to which the employee had a legal right before the negotiation.

To the extent that severance benefits are paid in lieu of deferred compensation amounts that would otherwise be subject to the rules, the severance benefits will be subject to the deferred compensation rules, regardless of whether they would otherwise satisfy one of the above-described exceptions.

Reimbursements and In-Kind Benefits

The Final Regulations substantially broaden the types of reimbursements and in-kind benefits that either are treated as satisfying certain of the requirements of section 409A or are exempt from the requirements of section 409A, and provide the following:

- Reimbursements or in-kind benefits will be treated as satisfying the deferred compensation requirements if, prior to the deadline for designating the time and form of payment for such benefits, the following are established:
    - The plan provides an objective definition of the in-kind benefits and expenses eligible for reimbursement.
    - The arrangement provides an objective period (including the life of the participant) during which the in-kind benefits or reimbursement of expenses will be provided.
    - The amount of the benefits provided or subject to reimbursement in one year cannot affect the amount of expenses eligible for reimbursement or in-kind benefits provided in another year.
    - Reimbursements are to be paid no later than the calendar year following the year in which the expense is incurred.
    - The right to in-kind benefits or reimbursement cannot be liquidated or exchanged for another benefit.
- A right to reimbursement under a separation pay plan will be exempt from the deferred compensation rules with respect to the following types of benefits:
    - Reimbursements of medical expenses during the period the employee would be entitled to health plan continuation coverage under COBRA if the employee elected such coverage and paid the premiums.
    - Reimbursements for reasonable outplacement and relocation services, and reimbursements of expenses that would be deductible as business expenses by the employee, to the extent the expenses are incurred during the period ending on the last day of the second calendar year following the calendar year in which the separation from service occurred, and provided

that the reimbursement occurs during the period ending on the last day of the third calendar year following the calendar year in which the separation from service occurred.

In many cases, rights to reimbursement under separation pay plans could also qualify as a reimbursement arrangement that satisfies the requirements as to designation of time and form of payment. The separation pay exemption for reimbursements, however, may be helpful if the overall limit on such benefits is to apply to a multi-year period (e.g., a maximum dollar amount over a two-year period), or if benefits are to be provided to key employees during the six-month period after separation from service, or both.

- Payments under a separation pay plan are exempt to the extent that the payments do not, in the aggregate, exceed the section 402(g) limit for the year in which separation of service occurs ($15,500 for 2007), subject to cost-of-living adjustments if the separation from service occurs in a future year.
- In-kind benefits will be deemed to be exempt from section 409A to the extent that reimbursement for such benefits would be exempt if the cost of the benefit was incurred by the employee.
- Tax gross-ups (such as those provided in connection with golden parachute taxes) will be considered to have satisfied the deferred compensation requirements as to a fixed time and form of payment if payment is made no later than the calendar year following the year in which the tax is paid.
- Reimbursements of certain educational expenses are exempt.

The above-listed exclusions for reimbursement and in-kind benefits may be used in combination, so that exemption of a type of benefit under one exemption does not preclude coverage of the benefit by another exemption. For example, the reimbursement of medical expenses following termination of employment might be exempt under the specific exemptions for benefits during the COBRA period, and could also be deemed to satisfy the requirements for deferred compensation during and after the COBRA period if the reimbursements meet the above-described rules for reimbursement that are available during an objectively specified period. In this example, the exemption during the COBRA period would permit the benefits to be provided during the six-month holdback period that would otherwise apply to key employees, and would permit those benefits to be treated as satisfying the requirements as to time and form of payment, thereby permitting them to continue after the end of the six-month period.

Settlements

The Final Regulations provide that the rules do not apply to court awards and bona fide settlements of claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers' compensation, or to payment or reimbursement of attorney fees incurred in connection with such claims. This exception generally does not apply to settlement of rights under a deferred compensation plan unless there is a bona fide dispute, payment of the undisputed amount is made in accordance with the applicable schedule, and the settlement is the result of bona fide negotiations. A payment is presumed not to qualify as a bona fide settlement unless the payment is subject to a substantial reduction from the amount that would have been payable in the absence of the dispute, with a reduction of less than 25% generally not being viewed as a substantial reduction.

Business Transactions

In the context of business transactions (e.g., mergers, acquisitions, and spin-offs) the parties frequently want to cash-out deferred compensation or cash-out or substitute existing equity-based compensation of the surviving entity. Although modifications and extensions of stock options and SARs may have adverse consequences under section 409A, the replacement or substitution of an NQO or SAR with another NQO or SAR in connection with a business transaction will not be treated as a modification or extension of the stock option or SAR if the replacement or substitution satisfies requirements that are similar to the requirements that would apply to the exchange of ISOs in such a transaction. Specifically, the replacement or substituted award may not give the employee additional benefits, the ratio of exercise price to fair market value of the replacement or substituted award after the transaction may not be greater than the ratio of exercise price to fair market value of the award given up, and the intrinsic value (i.e., the "spread") of the replacement or substituted awards may not exceed the intrinsic value of the award given up. Assuming that a stock option or SAR is not subject to section 409A, the cash-out of the award should not be subject to section 409A.

Generally, section 409A prohibits the accelerated cash-out of a deferred compensation arrangement by reason of a

change in control or other corporate transaction unless the change in control or other transaction constitutes a "change in control" that satisfies very specific requirements. We will provide a more detailed memorandum on business transactions in the near future. Generally, however, a transaction will not constitute a change in control for purposes of the section 409A rules unless all of the following requirements are satisfied:

- The determination of whether a change in control has occurred is objectively determinable under the provisions of the deferred compensation arrangement, and that determination may not permit the exercise of discretion (other than discretion that is purely ministerial).
- The transaction triggering the payment must satisfy one of the following requirements: (i) one person acquires more than 50% of the value of the stock or voting power of the company and the shares of the company remain outstanding after the acquisition; (ii) one person acquires stock with 30% or more of the voting power of the company; (iii) a majority of the board membership is replaced with individuals who have not been endorsed by the incumbent board (provided that no other company is a majority shareholder of the company); or (iv) more than 40% of the company's assets (determined based on the fair market value net of liabilities) are sold.
- The change in control must relate to: (i) a company that is liable for the payment of the deferred compensation (if the deferred compensation is attributable to services performed for such company or there is otherwise a legitimate business reason for such company to be liable for the payment); (ii) the company for whom the employee is providing services at the time of the change in control; or (iii) a majority shareholder of any of the foregoing companies.
- It is permissible to use a definition of change in control that does not satisfy the foregoing requirements if the change in control does not alter the time and form of payment, even if the occurrence of the change in control affects, for example, vesting.

Transition Rules

Section 409A applies to deferred compensation unless the compensation was both earned and vested on or before December 31, 2004. Amounts are not treated as earned and vested as of December 31, 2004, if, as of that date, the employer retained the discretion to reduce the amount, or the employee was required to perform additional services after December 31, 2004, in order to receive the compensation.

If the compensation was earned and vested on or before December 31, 2004, section 409A does not apply, and the compensation is said to be "grandfathered." The Final Regulations clarify that NQOs and SARs that were immediately exercisable on or before December 31, 2004, are treated as having been earned and vested on that date, and therefore are not subject to section 409A. The Final Regulations also provide that the grandfathered amount under a nonqualified defined benefit plan is the amount to which the employee would have been entitled if the employee voluntarily resigned on December 31, 2004, and received a form of payment having the maximum value.

However, section 409A applies to deferred compensation that was earned and vested on or before December 31, 2004 (i.e., the compensation will no longer be grandfathered), if the deferred compensation arrangement is materially modified after October 3, 2004. The Final Regulations provide that any such change will not be treated as a material modification for purposes of section 409A so long as the modification is rescinded before the earlier of: (i) the date any additional right granted by the modification is exercised, or (ii) the end of the calendar year in which the modification was made.

Non-US Plans

The Final Regulations provide extensive guidance regarding the application of section 409A to US citizens working outside the United States and participating in foreign plans, as well as for foreign taxpayers working in the United States. The Final Regulations provide that a deferred compensation arrangement is not subject to section 409A if the compensation subject to the arrangement would not have been includable in gross income under the Internal Revenue Code if it had been paid to the employee at the time that the legally binding right to the compensation arose, or at the time that the individual became vested, if later, and so long as the individual was a nonresident alien at such time. For example, if a nonresident alien working in a foreign country later retires to the United States, foreign source income that was deferred and vested while working in such foreign country, generally, will not be subject to section 409A.

Other deferred compensation not subject to section 409A includes: (i) deferrals of amounts that are exempt from US

taxation under an applicable treaty; (ii) deferrals of less than the Code section 402(g) limit ($15,500 for 2007) by nonresident aliens of US-source income under a foreign deferred compensation plan; (iii) deferrals by nonresident aliens and certain resident aliens under a "broad-based foreign retirement plan" as defined under the regulations; (iv) contributions to, or benefit accruals under a foreign plan if such contributions and accruals are excluded from income under an applicable tax treaty; (v) transfers to certain trusteed, funded arrangements; (vi) nonelective deferrals on behalf of US citizens and lawful permanent residents of "modified foreign source income," under a foreign broad-based retirement plan that do not exceed certain limits applicable to retirement plans that are qualified under US tax rules, provided that the participant is not eligible to participate in a US-qualified plan; (vii) deferrals of foreign earned income (within the meaning of Code section 911(b) and up to certain specified limits) of US citizens and residents living abroad; (viii) tax equalization payments that meet certain requirements; and (ix) certain foreign separation pay plans.

Further Information

A full discussion of the statute and the guidance provided by the IRS is beyond the scope of this memorandum. Clients should seek legal advice as to the application of section 409A to their particular arrangements by consulting with the lawyer who normally advises them with respect to such arrangements or one of the lawyers listed below.

If you did not receive this Client Update directly but would like to do so in the future, please send your request to info@mayerbrownrowe.com.

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