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The Good and the Bad: Selected Highlights From the Final 409A Regulations

United States Department of the Treasury (Treasury Department) and Internal Revenue Service (IRS) issued the long-awaited final regulations under Internal Revenue Code Section 409A on April 10, 2007. For the most part, the final regulations follow the format and adopt the substantive rules and analysis of the October 2005 proposed regulations and other interim guidance issued by the Treasury Department, but with several significant changes. Areas reserved under the proposed regulations — such as the calculation of amounts of deferrals and the timing of income recognition in the event Section 409A is violated — are still not addressed in the final regulations and will be covered in subsequent IRS guidance.

The extensive preamble to the final regulations addresses many of the comments filed with respect to the proposed regulations, but the regulations leave open many significant issues.

This briefing will discuss some, but certainly not all, of the more significant new rules, concepts, or clarifications included in the final regulations as well as some of the key issues left unaddressed.

For a more general review of the requirements of Section 409A and the interim guidance, please see the October 12, 2004, October 7, 2005, and February 1, 2006 issues of Legal News: Employee Benefits available at Foley.com. (Click on Publications and pull up the Tax & Employee Benefits legal practice newsletters.)

Documentation and Timing

- **Deadline for Amending Plans.** Section 409A requires that all nonqualified deferred compensation plans be in writing. Such plans or arrangements will need to be amended by December 31, 2007 to comply with the requirements of Section 409A.
- **Use of Savings Clauses.** The new regulations state that the use of general amendments or savings clauses, which reflect an intent to comply with the statutory requirements or which purport to negate noncompliant terms or to supply specific required provisions, will not be effective. As such, if a plan document contains a provision that violates the requirements of Section 409A or fails to contain a provision required by Section 409A, the plan will violate Section 409A even if it contains a “savings clause.”
- **Specified Employee Provisions.** Section 409A requires that nonqualified deferred compensation plans covering certain key executives of public companies must expressly provide that payments made to such executives upon separation from service be delayed for a period of six months following such separation. The final regulations provide that such

requirement must be incorporated into the plan document by the time the executive becomes a specified employee. As a result of this requirement, public companies may want to include the required delay provision in all nonqualified deferred compensation plans, which often include employment agreements, and private companies approaching an initial public offering (IPO) will want to amend their plans before the IPO is effective.

Anti-Abuse Rule

- The final regulations contain a generic “anti-abuse” rule under which the IRS may treat any plan or arrangement with a principal purpose of deferring compensation inconsistent with the purposes of Section 409A as subject to Section 409A.
- An additional “anti-abuse” rule is included in the controlled group rules used to determine whether an entity is eligible to issue options and stock appreciation rights (SARs) that are not subject to Section 409A. Under this rule, otherwise-excluded options and SARs may be brought under Section 409A if a purpose (whether or not a principal purpose) of the controlled group structure was to provide nonqualified deferred compensation not subject to Section 409A.

Stock Options and SARs

- The provisions of the final regulations dealing with stock options, SARs, and other equity rights contain several changes that will make it easier to create equity rights programs excluded from Section 409A. The final regulations, however, provide little new helpful guidance regarding the critical issue of the determination of the value of private company stock for purposes of Section 409A. Thus, the use of options or SARs in private company situations continues to be potentially problematic.
 - **Extensions of Exercise Periods.** The final regulations significantly expand the period for which the right to exercise an option or SAR may be extended without causing the option or SAR to be subject to Section 409A. Under the final regulations, where an option or SAR provides for a shortened exercise period in certain events — such as termination of service — the shortened period may be subsequently extended until the earlier of the original general term of the stock right or the 10th anniversary of the date of grant. For example, if an option was granted with a 10-year term, but by its terms is exercisable for only 30 days following an earlier termination of service, under the final regulations, the post-termination exercise period may be extended
- for any period up to the full original term without subjecting the option to Section 409A. Under the proposed regulations, the extension period generally was limited to the end of the calendar year in which the termination occurred.
- **Service Recipient Stock.** As under the proposed regulations, the final regulations provide that only options and SARs granted with respect to service recipient stock potentially are excluded from Section 409A. By modifying the definition of service recipient stock and clarifying which entities may issue such stock, the final regulations provide greater flexibility in creating options and SARs excluded under Section 409A.
 - Under the final regulations, options and SARs excluded from Section 409A may be granted with respect to any class of common stock. Under the proposed regulations, excludible options or SARs could be granted only with respect to the most widely held class of common stock in the case of a private company or the class that was publicly traded in the case of public companies.
 - Under the proposed regulations, the issuer of the stock subject to the option or SAR was, in most cases, limited to the ultimate parent corporation in a chain of controlled corporations. The final regulations allow any corporation from the employer receiving the services that are the basis for the grant up to the ultimate parent corporation to be the issuer of the stock subject to the option or SAR.
 - Under the proposed regulations, the common stock could have no preference over any other class of common or other stock. The final regulations allow the stock subject to an option or SAR to have a liquidation preference.
 - **Valuation.** As only nondiscounted stock options and SARs potentially are excludible from Section 409A, clear and practical rules for determining the value of private company stock is critical. One area where employers likely will be disappointed with the final regulations is the lack of new guidance given with respect to the valuation of private company stock. The final regulations make no material changes to the valuation rules set forth in the proposed regulations. As a result, the use of options or SARs in private companies (other than a valuation based on a formal appraisal) continues to be highly risky from the perspective of the individual receiving the grant.

Separation Pay Plans

- The final regulations make a number of significant changes to the rules governing separation pay plans. A number of the new provisions offer welcome guidance, but traps for the unwary continue to exist in this area, particularly where an existing severance benefit is being revised immediately prior to a termination.
- **Exclusions.** The final regulations retain and supplement the provisions of the proposed regulations excluding limited categories of post-termination benefit continuation or reimbursement plans from Section 409A.
- **Involuntary Terminations or Window Programs.** The final regulations adopt the provisions of the proposed regulations that exclude from Section 409A rights to payments following an involuntary separation from service or payable under a window program of up to the lesser of two times the employee's annual compensation or two times the Internal Revenue Code Section 401(a)(17) qualified plan compensation limit. However, the final regulations are ambiguous as to how an employee's annual compensation is computed for purpose of this exclusion.
- **Involuntary Terminations/Excess Payments.** The final regulations also make clear that, where the amount of the payments exceeds the annual compensation/Section 401(a)(17) limit for exclusion, only the excess amount potentially is subject to Section 409A. This clarification is particularly important for those executives who are "specified employees" and, as a result, subject to the six-month payment delay. For such executives, this clarification allows for payments up to the limit to be made during the six-month period following an involuntary termination.
- **Good Reason.** As requested in many comments filed with respect to the proposed regulations, the final regulations recognize that where an employee resigns for "good reason" the termination should be considered involuntary. The final regulations include a safe harbor definition of "good reason" to include (i) a material diminution in base compensation (but not bonus compensation or benefits), (ii) a material diminution of authority, duties, or responsibilities of the employee, (iii) a material diminution in the budget over which the employee has responsibility, (iv) a material change in the geographic location at which the services are performed, or (v) a material breach by the employer of the agreement under which the employee performs services. Employers will want to consider amending existing employment agreements, particularly for "specified employees," to conform to the good reason definition in the regulations.
- **Voluntary Terminations.** Under the final regulations, payments made as a result of a voluntary termination are subject to Section 409A and whether a termination is voluntary or involuntary is based on the facts and circumstances. The basic standard for an involuntary termination is the independent exercise by an employer of its unilateral authority to terminate the employment of an employee. How such determinations will be made where, for example, an employee retires or resigns under pressure, is less than clear.
- **Changes in Benefits at the Time of Termination.** The principal area where inadvertent violations of Section 409A may occur is where the terms of an employee's benefits are modified as part of the negotiations for the employee's termination. For example, the regulations make clear that where new separation benefits are added at the same time other nonqualified deferred compensation benefits are forfeited as a result of a termination, the new benefits may be characterized as an acceleration of payment of all or a portion of the forfeited benefits in violation of Section 409A. Where this situation arises in connection with a voluntary termination, the added benefits are presumed to violate Section 409A.
- **Reimbursements.** The final regulations adopt the exclusions in the proposed regulations for post-termination continuation of benefits or reimbursements for a period of up to two years that would be tax-free to or tax-deductible by a former executive as a business expense. The final regulations also set forth conditions under which taxable reimbursement rights, including those extending beyond a two-year period, while subject to Section 409A, may comply with the requirements of Section 409A. This provision seems to clear up concerns that many commentators had regarding whether extended health care reimbursement benefits could meet the requirement that there be a fixed schedule of payments.
- **Golden Parachute Payments.** The final regulations clarify that tax gross-up payments — such as some agreements require with respect to parachute payments — constitute a right to deferred compensation. The regulations go on to provide that, if the plan provides that the gross-up payment will be made, and such payment is made, before the end of the executive's tax year following the year when the related taxes are paid, the requirements of Section 409A will be satisfied.

Separation From Service

- Separation from service is one of the permitted events which can cause the payment of nonqualified deferred compensation under Section 409A. The final regulations provide clearer rules, and certain presumptions, regarding when an employee will be considered to have separated from service so as to permit the payment of deferred compensation.
- **General Standard.** The general standard under the final regulations is whether the facts and circumstances indicate that the employer and employee reasonably anticipate that no further services will be performed by the employee after a certain date or that the level of services the employee will perform (whether as an employee or independent contractor) will permanently decrease to no more than 20 percent of the average level of services performed over the preceding 36 months.
- **Presumptions.** Under the regulations, there is a rebuttable presumption that a separation from service has occurred where the post-termination service level is 20 percent or less than the pre-termination service level. A rebuttable presumption that no separation from service has occurred will arise where the level of post-termination service is 50 percent or more of the pre-termination service level.
- **Phased Terminations.** The final regulations also allow plans to provide for a separation from service to occur at the time the employer and employee reasonably anticipate a permanent reduction of the level of service to a specified percentage between 20 percent and 50 percent. In order to take advantage of this provision, the plan must include this provision when the time and form of payment are elected or otherwise specified. For example, an employment agreement that for the first time provides an executive with a defined level of severance pay following a separation from service may, at the time the agreement is first entered into, provide for an alternative definition of separation from service under this rule.
- **Rehire.** The final regulations make clear that where an employee who has had a separation from service is rehired, it would be a violation of Section 409A to suspend payment of nonqualified deferred compensation triggered by the separation from service. Presumably, the employee could forfeit unpaid deferred compensation as a condition to re-employment.

- **Documentation.** Employers likely will want to amend employment agreements and other plans providing for the commencement of nonqualified deferred compensation based upon a termination of employment to incorporate the separation from service definitions in the final regulations.

Specified Employees

- **General Rule.** A requirement of Section 409A is that payments under a nonqualified deferred compensation plan for certain key employees of public companies (called “specified employees”) upon their separation from service be delayed for the six-month period immediately following the executive’s separation from service. The final regulations clarify the rules for determining which executives are subject to this requirement, particularly following corporate transactions such as mergers or other acquisitive transactions.
- **Identification and Effective Dates.** The final regulations require public companies to specify a date as of which specified employees are identified each year and the effective date of such identification. If no date is selected, the identification date is December 31 each year. The effective date is any designated date on or prior to the first day of the fourth month following the identification date. If no date is designated, the first day of the fourth month following the identification date is the effective date.
- **Effect of Determination.** An executive who meets the requirements of a specified employee on any date during the 12-month period ending on the identification date will be considered a specified employee for the entire 12-month period beginning on the next effective date.
- **Corporate Transactions.** The final regulations also include rules for determining which executives are considered specified employees following mergers and other acquisitions transactions among public companies or public and private companies. The final regulations also clarify an ambiguity in the proposed regulations and make clear that a specified employee ceases to be treated as a specified employee following a going private transaction.
- **Periodic Payments and Reimbursement Rights.** The preamble to the final regulations make it clear that periodic payments and reimbursement rights subject to Section 409A are subject to the six-month delay rule for specified employees.

ABOUT FOLEY

The Employee Benefits attorneys of Foley & Lardner LLP counsel employers on employee benefits and executive compensation matters to reduce exposure to employee complaints, governmental agency actions, and union-related problems. We counsel on 401(k), profit sharing, employee stock ownership, pension and supplemental retirement plans as well as health, dental, disability, life insurance, severance, cafeteria, and flexible benefits plans. Our counsel also extends to Medicare and Social Security benefits, COBRA compliance, and post-retirement benefits issues. We also advise clients in resolving benefits issues arising in mergers and acquisitions. We work closely with Foley trial lawyers who represent corporations and their benefit plans in litigation involving employment benefits and other obligations under ERISA.

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Effective Date and Transitional Rules

- **Effective Date.** The final regulations are effective as of January 1, 2008, although they may be relied on for 2007 and prior years.
- **Transition Rules.** Employers may continue to rely on the proposed regulations and other guidance prior to January 1, 2008, subject to certain exceptions.
- **Stock Rights.** Stock rights issued after April 10, 2007, which do not conform to the final regulations, will have to be modified to conform by December 31, 2007.
- **Deferral Elections.** If a plan established prior to April 10, 2007, under a good faith interpretation of Section 409A and the interim guidance would allow an initial deferral election to be made after December 31, 2008, the deferral election will need to be made by December 31, 2008.