

Final Code Section 409A Regulations: What's New, What's Not Covered and What Do You Do Now?

DrinkerBiddle

On April 10, 2007, the Internal Revenue Service (the "IRS") finally issued the long-awaited final regulations under Internal Revenue Code ("Code") section 409A. The regulations were originally proposed in 2005 and were the subject of considerable comments by employers and practitioners. Originally proposed to be effective January 1, 2007, the IRS was forced to delay the effective date (*see* IRS Notice 2006-79) when it became clear the final regulations would not be released in time to give employers and other service recipients time to comply with the regulations by the proposed effective date. The final regulations are generally applicable January 1, 2008, with delayed compliance dates for certain collectively bargained plans or arrangements. As discussed in detail below, plans must be amended for compliance with the final regulations on or before December 31, 2007.

BACKGROUND

Code section 409A, which was enacted as part of the American Jobs Creation Act of 2004, imposes a variety of rules and requirements on nonqualified deferred compensation arrangements. Generally, the rules relate to the timing of deferral elections, distribution requirements and changes in distribution elections. Code section 409A also contains prohibitions on certain funding arrangements and contains reporting requirements.

This Alert focuses on changes and clarifications in the final regulations, as well as areas where guidance is still needed. We recommend a list of action steps that all sponsors of nonqualified deferred compensation plans and arrangements should be taking now to ensure compliance with the final regulations by December 31, 2007.

WHAT'S NEW

Exceptions and Exclusions

Separation Pay

The final regulations clarify that separation pay is compensation to which an employee's right is conditioned upon a separation from service (including separa-

tion from service due to death or disability) and not compensation an employee could receive without separating from service (e.g., an amount payable upon a change in control or unforeseeable emergency) or could have elected to receive under other circumstances. Additionally, the final regulations state that compensation provided under an involuntary separation pay arrangement, which is payable no later than the end of the second taxable year following an employee's separation from service, is excluded from Code section 409A up to an amount equal to the lesser of (i) two times the employee's annualized compensation based on his or her rate(s) of pay for the year before the year of the separation from service, or (ii) two times the limit on compensation under Code section 401(a)(17) for the year of the separation from service (\$225,000 for 2007). This exclusion applies even if the total amount of the compensation exceeds these limits, but amounts that exceed the duration limit or the monetary limit are subject to Code section 409A. Accordingly, a "specified employee" (*see* "Specified Employees" in "Payment Provisions," below) may receive separation pay up to this monetary limit subsequent to a separation from service without having to wait for a six-month period to expire.

"Good Reason" Terminations

The final regulations apply a facts and circumstances test for determining whether a voluntary termination for "good reason" is considered an involuntary termination and they provide a safe harbor for making this determination. The safe harbor requirements include:

- the amount payable in connection with a good reason termination must be payable only if the employee separates from service within two years following the initial existence of the condition that constitutes good reason;
- the amount, time and form of payment upon a termination for good reason must be substantially identical to the amount, time and form of payment upon an involuntary termination; and
- the employee must be required to provide notice of the existence of the good reason condition within 90 days

WE'VE COMBINED

On January 1, 2007, Drinker Biddle & Reath LLP and Gardner Carton & Douglas LLP merged to form one of the 70 largest law firms in the United States, with more than 630 lawyers located in 12 cities nationwide. The firm is known as Drinker Biddle & Reath LLP. In Illinois and Wisconsin, the firm will do business as Drinker Biddle Gardner Carton for a transitional period.

following the initial existence of such condition and the employer must be provided at least 30 days to remedy the good reason condition.

For these purposes, a good reason condition may consist of one or more of the following conditions which arise without the consent of the employee:

- a material diminution in the employee's base compensation;
- a material diminution in the employee's authority, duties or responsibilities;
- a material diminution in the authority, duties or responsibilities of the supervisor to whom the employee is required to report, including a requirement that an employee report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar governing body);
- a material diminution in the budget over which the employee has authority;
- a material change in geographic location at which the employee must perform services; or
- any other action or inaction that constitutes a material breach of the terms of an employee's employment agreement.

If there is good reason for an employee's termination, the employee's termination will be considered "involuntary" for purposes of applying the separation pay exception to Code section 409A. Additionally, if there is good reason for an employee's termination, amounts paid in connection with such termination are considered to have been subject to a substantial risk of forfeiture for purposes of applying the short-term deferral exception under Code section 409A (see "Short-Term Deferrals," below).

Equity Compensation Arrangements

The final regulations contain several additions and clarifications to the provisions exempting options and stock appreciation rights ("SARs") from the provisions of Code section 409A, including the following:

- The definition of "service recipient stock" has been expanded so that the option or SAR may be granted with respect to any common stock of the employer or certain corporations that have a direct or indirect "controlling interest" in the employer. (The proposed regulations required that the option or SAR be granted on common stock that was readily tradable on an established securities market or, if there was no such common stock in the employer's group, the common stock having the highest aggregate value.)
- Generally, the extension of the term of an option or SAR causes the option or SAR to be retroactively subject to Code section 409A, unless the extension does not go be-

yond the original term of the option or SAR or, if earlier, 10 years after the date of grant. (In most cases, this is a much longer period than permitted under the proposed regulations.) For an "underwater" option or SAR, however, this limit on the extension period is not applicable, and the extension is treated as a new grant.

- The final regulations contain a number of clarifications regarding valuation applicable to nonqualified (non-statutory) stock options and SARs. The regulations also provide additional guidance on valuations that are based on an average selling price over a period that is within 30 days of the date of grant.

We will be issuing a more detailed alert discussing the equity compensation provisions of the final regulations in the next few weeks.

Short-Term Deferrals

Generally, to be eligible for the short-term deferral exception, the regulations require payment to be made within 2½ months after the end of the year in which the compensation is no longer subject to a substantial risk of forfeiture. The proposed regulations contained limited exceptions to this rule when payments were delayed due to unforeseeable events or when the payment would jeopardize the employer's solvency. The final regulations no longer follow the employer's solvency or insolvency standard. Instead, if the payment would jeopardize the ability of the employer to continue as a going concern, such payment may be delayed. Additionally, if payment is made in a series of installments that is not an annuity, the short-term deferral rule has been expanded so that it may apply to installments paid before the end of the 2½-month period, even though the installments continue beyond the 2½-month period. A plan that provides for payments on a date that may be, or an event that may occur, later than the end of the 2½-month period does not fall within the short-term deferral exception even if payments are actually made within the 2½-month period.

Application of Code Section 409A to 457 Plans

Code section 409A is not applicable to an eligible deferred compensation plan under Code section 457(b) but may be applicable to a deferred compensation plan that is subject to Code section 457(f). The final regulations provide generally that amounts deferred under Code section 457(f) and earnings thereon are exempt from Code section 409A under the short-term deferral exception provided that such amounts are distributed no later than the 15th day of the third month following the later of the end of the employee's taxable year or the end of the employer's taxable year in which the amounts deferred (including earnings) are no longer subject to a substantial risk of forfeiture.

Reimbursement and Fringe Benefit Plans

Following an employee's separation from service, certain plans under which an employer reimburses certain types of expenses incurred by an employee are not subject to Code section 409A if such reimbursements are available only for expenses incurred within a limited period of time. Under the final regulations, the reimbursement period is extended for certain expenses (e.g., outplacement services, moving expenses) to the end of the third year following the employee's separation from service, as long as the expenses are incurred no later than the end of the second year following the employee's separation from service. The final regulations also clarify that a right to a benefit that is excludable from income, such as an arrangement to provide health coverage excludable under Code section 105, is not a deferral of compensation under Code section 409A. The final regulations also state that taxable reimbursements of medical expenses may be provided without being subject to Code section 409A during the entire period that the employee would be entitled to "COBRA" coverage under a group health plan of the employer if the employee elected such coverage and paid the applicable premiums.

Indemnification Arrangements

The final regulations clarify that an employee's right to the payment of contingent amounts pursuant to an employer's indemnification for expenses incurred or damages paid as a result of a legal claim related to the employee's performance will not be treated as the right to deferred compensation for purposes of Code section 409A. A similar rule applies with respect to an employee's right to liability insurance coverage providing for such payments in the event of a law suit.

Independent Contractors

Generally, Code section 409A does not apply to independent contractors if in the year the independent contractor obtains a legally binding right to the deferred amount, the independent contractor is providing significant services to two or more companies which are unrelated to the independent contractor or to one another. The final regulations retain the 70% safe harbor in the proposed regulations to define significant services. However, they have added a three-year look-back period. An independent contractor who has actually met the 70% safe harbor in the three immediately previous years will be deemed to meet the 70% safe harbor for the year of deferral, but only if at the time the amount is deferred, the independent contractor does not reasonably anticipate that he or she cannot meet the safe harbor in that year. This exception to Code section 409A does not apply to deferred amounts attributable to services as a member of a board or to management services (financial or operational direction or control; investment management or advisory services).

Payment Provisions

Specified Payment Date

The final regulations provide that a payment made within the 30 days before the scheduled date of payment will be deemed made on the scheduled date, as long as the participant is not permitted to designate the taxable year of the payment. The plan or arrangement may also specify a period (e.g., January 1 through July 1 of a specific year) during which payment is to be made. However, the period may not be stated as "not later than July 1," because that would permit payment before January 1. Where payment is to be made upon an event (such as separation from service), the plan or arrangement may provide that payment will occur either within a period in a specified tax year of the participant or within a period of not more than 90 days (as long as the participant cannot elect the tax year of the payment).

Different Times and Forms of Payment under Different Circumstances

Under the regulations, a time and form of payment must be specified with respect to each permissible payment event. The proposed regulations permitted a second time and form of payment to be specified where the distinction was based upon the event occurring before or after a certain age such as a lump sum payment if the employee terminated before age 55 and installment payments if the employee terminated on or after age 55. The final regulations provide that the time and form of payment following a separation from service may vary depending upon one or both of the following: (i) whether the separation occurs during a period of time not to exceed two years following a change in control event; and (ii) whether the separation occurs before or after a specified date, or a combination of a specified date and a specified period of service (such as a retirement date based on age alone, or based on a combination of age and service). Although requested by commentators, the final regulations do not permit a different time or form of payment to be specified based on whether the separation from service is voluntary or involuntary.

Subsequent Changes to Time and Form of Payment

The proposed regulations permitted taxpayers to treat actuarially equivalent life annuities as one form of payment, thereby permitting elections among such annuity forms at any time before the initial annuity payment, without regard to the rules on subsequent deferral elections. The final regulations clarify the circumstances when two actuarially equivalent life annuities are treated as one form of payment. Under the final regulations, certain features will be ignored when determining whether a particular annuity is treated as a life annuity. Some of these features include: (i) term certain features; (ii) pop-up provisions (under which the payments increase following the death of the beneficiary or another event that eliminates the right to a survivor annuity); (iii) certain cash refund features; (iv) Social Security or Railroad Retirement leveling features; and (v) features applying a permissible cost-of-living index. Additionally, the final regulations provide that in determin-

ing whether two life annuities are actuarially equivalent, the same assumptions and methods must be used for valuing each one. Finally, a subsidized joint and survivor annuity and a single life annuity may be treated as a single form of payment, provided that each of the annual lifetime and survivor benefit under the subsidized joint and survivor annuity is not greater than the annual lifetime annuity benefit available under the single life annuity.

Multiple Payment Events

Under the final regulations, a plan may provide for a payment based upon the earlier of, or the later of, a series of events, provided that each payment event would otherwise satisfy the requirements of Code section 409A. For example, a plan may provide that a payment will occur as of the earlier of a participant's separation from service or the occurrence of a change in control. The final regulations also clarify that the rules regarding subsequent changes in time and form of payment apply separately to each payment event.

Cashout Rule

In accordance with the final regulations, any time a participant's amount deferred under a plan is less than a specified dollar amount, an employer may exercise discretion to cash out the participant's entire amount deferred under the plan, even prior to the participant's separation from service. The final regulations increase the limit on the cashout amount to the limit on elective deferrals under Code section 402(g) (\$15,500 in 2007). The cashout must, however, end the participant's participation in the plan and all similar nonqualified deferred compensation plans.

Specified Employees

Code section 409A requires that nonqualified deferred compensation payments to "specified employees" of public companies (or of any employer within the public company's controlled group of entities) that are made due to the employee's separation from service may not be made before the date which is six months after the separation from service. An employee is a specified employee if the employee is a "key employee" within the meaning of Code section 416. Generally, this includes certain 1% and 5% owners of the employer, and officers of the employer. Only the top 50 officers, when ranked by compensation, are included (or, if less, the greater of three employees or 10% of the number of employees).

Because compensation varies each year, the key employee determination can also vary from year to year. Under the proposed regulations, the determination of who is a key employee was made using compensation for a 12-month period ending on the employee identification date (December 31, unless the employer elected otherwise). The designation applied to distributions made for the 12-month period beginning on the first day of the fourth month following the employee identification date (April 1, for a December 31 employee identification date).

The final regulations include a number of additions and clarifications to the specified employee provisions, including the following:

- The six-month delay for payment to specified employees applies to employers whose stock (or the stock of any of the employer's controlled group members) is traded on a foreign exchange.
- Any available definition of compensation under Code section 415 may be used in the specified employee determination.
- A plan can be overinclusive in identifying key employees. For example, a plan could either use an alternative, objective method of identifying key employees, as long as no more than 200 employees are identified as subject to the six-month delay as of any date, or could provide that all employees are subject to the six-month delay.
- An employer may elect an earlier date following the employee identification date for applying the determination of specified employees, as long as such date is not later than the first day of the fourth calendar month following the employee identification date.
- Significantly more clarification is provided on determining specified employees following a corporate transaction, including mergers and acquisitions of public companies, public and private companies, spin-off transactions and initial public offerings.

Change in Control

The change in control provisions are generally similar to those in the proposed regulations, although the threshold for determining a change in the effective control of a corporation has been lowered from 35% to 30%. We will be issuing a more detailed alert discussing the change in control provisions of the final regulations in the next few weeks.

Salary Continuation Arrangements

The final regulations provide that a salary continuation plan does not delay the separation from service date. Typically, under a salary continuation program, the employee continues to receive salary and benefits, although he or she is not required to perform any further meaningful services.

Rehired Employees

The final regulations address rehires of individuals who are receiving nonqualified plan payments, and specifically provide that suspension of nonqualified plan payments being made due to a prior separation of service is not permitted if the individual is rehired. Although the IRS notes that many of the desired results of a suspension of benefits may be obtained through deferrals of future compensation after rehire, this may not be the case if the individual is rehired into a position that is not eligible for deferrals under a nonqualified plan.

Documentation

Written Plan Requirement

A plan must be in writing to comply with Code section 409A. The final regulations clarify that the document or documents constituting the plan must specify, at the time an amount is deferred, the amount to which the participant has a right to be paid or the terms of the applicable formula and the payment schedule or payment triggering events that will result in a payment of the amount. Additionally, the final regulations state that a plan must provide for the six-month delay requirement applicable to payments to specified employees upon a separation from service no later than the time the provision may be applicable to a separation from service of the specified employee (which may be significant in the event that a private company goes public). Also, general Code section 409A compliance provisions in a plan will be disregarded for purposes of determining whether a plan is compliant with Code section 409A (i.e., a “savings clause” will not bring a plan into compliance if the plan contains non-compliant provisions).

Plan Amendment Requirements

In accordance with the final regulations, plans must be amended to be compliant with Code section 409A on or before December 31, 2007 to bring plan documents into compliance effective January 1, 2008. Plan documents are not required to reflect any amendments made or actions taken under the transition rules to the extent such amendments or actions do not affect the plan’s compliance with Code section 409A and the final regulations for periods on and after January 1, 2008. Additionally, plans do not need to be amended for compliance with Code section 409A with respect to amounts deferred under a plan that were paid on or before December 31, 2007 in accordance with transition guidance; however, there must be evidence that a plan was operated in accordance with the transition guidance.

Miscellaneous Provisions

Plan Aggregation Rules

Under the proposed regulations, nonqualified deferred compensation plans were aggregated into four groups: account balance plans, nonaccount balance plans, separation pay plans due to involuntary termination of employment or participation in a window program, and deferrals under all other plans. The aggregation rules apply for a number of purposes, including the plan termination, initial eligibility, and penalty provisions. The final regulations add several new categories of plans, including split-dollar life insurance arrangements, reimbursement plans, and stock rights that constitute non-qualified deferred compensation plans. In addition, the final regulations provide that account balance plans can be subdivided into separate categories for amounts deferred under an elective deferral arrangement (and earnings on such amounts) and nonelective deferrals, provided such amounts can be separately identified.

Initial Eligibility

Generally, deferral elections must be made prior to the beginning of the year in which the services relating to the deferred compensation will be performed. However, in the first year in which the service provider becomes eligible to participate in the plan, an initial deferral election may be made within 30 days of such initial eligibility. Because of the plan aggregation rules, application of this rule under the proposed regulations was unclear in instances where individuals were rehired or transferred between eligible and ineligible positions. The final regulations provide that the 30-day rule is available to service providers who have not been an active participant in the plan (applying the plan aggregation rules) for at least 24 months. For this purpose, a service provider is an active participant in the plan if the service provider is eligible to accrue benefits under the plan (even if the individual elected not to participate), other than earnings on amounts previously deferred.

Performance-Based Compensation

Code section 409A provides that in the case of any performance-based compensation attributable to services performed over a period of at least 12 months, a participant’s initial deferral election may be made no later than six months before the end of the period.

The final regulations have introduced the following clarifications and changes for purposes of determining whether compensation is performance-based:

- If a portion of an award would qualify as performance-based compensation if that portion were the sole amount available under the plan, such portion will qualify as performance-based if it is designated separately or otherwise separately identifiable under the plan, and if the performance-based and non-performance-based portions are determined independently of one another;
- The participant is only required to perform services from the later of (i) the date the performance period starts, or (ii) the date the performance criteria are established, through the date of the initial deferral; and
- The deferral election must be made before the amount is readily ascertainable.

Tax Gross-Up Payments

The final regulations clarify how Code section 409A applies to tax gross-up payments. Under the final regulations, the right to a tax gross-up payment is nonqualified deferred compensation that satisfies Code section 409A if the plan provides that the tax gross-up payment will be made (and payment is actually made) by the end of the service provider’s taxable year in which the related taxes are remitted to the IRS or other taxing authority.

The final regulations also address reimbursements of expenses related to a tax audit or litigation. In that case, the arrangement must provide (and reimbursement must be made) by the later of (i) the end of the year in which the taxes that are the subject of the audit or litigation are remitted to the taxing authority, or (ii) if no taxes are to be remitted, the end of the service provider's taxable year next following the year in which the audit or litigation is completed.

Nonqualified Deferred Compensation Plans Linked to Tax-Qualified Plans

In general, a nonqualified deferred compensation plan may be linked to a tax-qualified plan without violating the timing rules for deferral elections or the anti-acceleration rules of Code section 409A only under limited circumstances. In regard to this issue, the final regulations extend relief to benefit formulas that include a reduction for amounts credited to the participant's account under a tax-qualified plan (which may include matching contributions). Additionally, the final regulations clarify that the linked plan relief provided for elective deferrals (including designated Roth contributions) and matching contributions, each up to the Code section 402(g) limit on elective deferrals, are separate, additive limits, not a single coordinated limit. For this purpose, the Code section 402(g) limit is increased by the limit on catch-up contributions under Code section 414(v) for any year in which the participant qualifies for such increase.

Plan Termination and Liquidation

The final regulations change the period during which an employer may not commence a new plan after terminating and liquidating an existing plan by reducing the five years provided in the proposed regulations to three years. Additionally, the rules for termination and liquidation of a plan following a change in control have been clarified to provide that the employer must, within the 30 days before or the 12 months after the change in control, take all necessary steps to irrevocably terminate the plan.

GUIDANCE STILL NEEDED

The final regulations do not address every area of concern with respect to Code section 409A. A number of significant areas still need to be addressed, for example: (i) treatment of equity interests in certain noncorporate entities; (ii) treatment of arrangements between partnerships and partners; (iii) calculation and timing of income inclusion amounts; and (iv) reporting and withholding.

WHAT TO DO NOW

- **Identify All Nonqualified Arrangements.** Identify all nonqualified deferred compensation plans and arrangements that are subject to the final regulations. Note that these may not always be traditional nonqualified plans, but could be contained in employment agreements and other documents. Many employers have already taken this step under the proposed regulations, but the plans and arrangements identified should be reconsidered.
- **Review All Plans and Arrangements for Compliance with Final Regulations.** All nonqualified deferred compensation plans and arrangements should be reviewed for compliance with the final regulations, even if they were previously reviewed for compliance with the proposed regulations. As noted above, there are a number of differences between the proposed and final regulations, including more specific guidance with respect to what needs to be in the written document.
- **Prepare Needed Amendments.** Revise all nonqualified deferred compensation plans and arrangements to incorporate all applicable changes noted above.
- **Execute Revised Documents by December 31, 2007.** Determine who has the authority to adopt the revised documents. In some cases, this may be the board of directors or compensation committee, in which case it will be necessary to determine the schedule of upcoming board or committee meetings and the deadlines for submitting documents and proposals at those meetings. In other cases, the authority for adoption may have been delegated to an officer of the company. If revised documents will be executed by an officer, make sure that the individuals responsible for Securities and Exchange Commission ("SEC") reporting are advised when the document is executed, so it can be filed with the SEC, if necessary.
- **Review Enrollment Materials and Other Participant Communications.** Review enrollment materials for 2008 deferrals and other participant communications to ensure they are consistent with the final regulations and revised plan documents.

Employee Benefits & Executive Compensation Team

Kathleen O'Connor Adams
(312) 569-1306
Kathleen.Adams@dbr.com

Gary D. Ammon
(215) 988-2981
Gary.Ammon@dbr.com

Marla B. Anderson
(312) 569-1314
Marla.Anderson@dbr.com

Jason L. Brodsky
(215) 988-2581
Jason.Brodsky@dbr.com

Mark M. Brown
(215) 988-2768
Mark.Brown@dbr.com

Barbara A. Cronin
(312) 569-1297
Barbara.Cronin@dbr.com

Mona Ghude
(610) 993-2241
Mona.Ghude@dbr.com

Megan Glunz Horton
(312) 569-1322
Megan.Horton@dbr.com

Sharon L. Klingelsmith
(215) 988-2661
Sharon.Klingelsmith@dbr.com

Tina Kuska
(312) 569-1320
Tina.Kuska@dbr.com

David Levin
(202) 230-5181
David.Levin@dbr.com

Howard J. Levine
(312) 569-1304
Howard.Levine@dbr.com

Benjamin S. Lupin
(215) 988-2905
Benjamin.Lupin@dbr.com

Joyce L. Meyer
(312) 569-1305
Joyce.Meyer@dbr.com

Sarah Bassler Millar
(312) 569-1295
Sarah.Millar@dbr.com

Joan M. Neri
(973) 549-7393
Joan.Neri@dbr.com

Jean D. Renshaw
(610) 993-2259
Jean.Renshaw@dbr.com

Michael D. Rosenbaum
(312) 569-1308
Michael.Rosenbaum@dbr.com

Lori L. Shannon
(312) 569-1311
Lori.Shannon@dbr.com

Veronica Silva-Minin
(312) 569-1323
Veronica.Silva-Minin@dbr.com

David L. Wolfe
(312) 569-1313
David.Wolfe@dbr.com

PARALEGALS

Carol C. Abing
(414) 221-6045
Carol.Abing@dbr.com

Vicki L. Beckenbaugh
(312) 569-1513
Vicki.Beckenbaugh@dbr.com

Mary K. Meschler
(215) 988-2751
Mary.Meschler@dbr.com

Carrie Roberts Rivera
(312) 569-1514
Carrie.Rivera@dbr.com



LAW OFFICES | CALIFORNIA | DELAWARE | ILLINOIS | NEW JERSEY
NEW YORK | PENNSYLVANIA | WASHINGTON DC | WISCONSIN

Disclaimer Required by IRS Rules of Practice: Any discussion of tax matters contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding any penalties that may be imposed under Federal tax laws.

© 2007 Drinker Biddle & Reath LLP. All rights reserved.
A Delaware limited liability partnership

Jonathan I. Epstein and Edward A. Gramigna, Jr., partners in charge of the Princeton and Florham Park, N.J., offices, respectively.

This Drinker Biddle & Reath LLP communication is intended to inform our clients and friends of developments in the law and to provide information of general interest. It is not intended to constitute advice regarding any client's legal problems and should not be relied upon as such.