



IRS Issues Final Section 409A Regulations

On April 10, 2007, the IRS and the Treasury Department issued the long awaited final regulations under Section 409A of the Internal Revenue Code ("Code"). Section 409A was added to the Code in 2004 and imposes significant new requirements and restrictions on "deferred compensation plans" – a category that includes a wide variety of commonly used compensation arrangements. The final regulations – all 397 pages of them -- make a number of important changes to the complex new rules. **In particular, the final regulations confirm that all covered plans and agreements must be amended no later than December 31, 2007 to comply with Section 409A.**

Effective Date

The regulations are fully effective on January 1, 2008. In the meantime, employers must continue to comply with a good faith interpretation of Section 409A's requirements, taking into account IRS guidance that has been issued since the law was enacted. Employers can, however, rely on the final regulations prior to their January 1, 2008 effective date. In any case, **all deferred compensation plans, agreement and arrangements must fully comply with the final regulations, including the documentation requirements, beginning on January 1, 2008.**

What Employers Must Do

Now that the final regulations have been issued, and will take full effect within 7 months, employers who haven't yet fully addressed the impact of Section 409A must do so. At minimum, they should:

- Review and analyze which of their plans and agreements are subject to Section 409A, in light of the definition of "deferred compensation" and the applicable exemptions set forth in the final regulations.
- Determine whether any plan changes are needed.
- Create and approve written plan documents for all covered arrangements, in compliance with the documentation requirements of the final regulations.

Overview of Section 409A Requirements

Section 409A regulates a broad category of "deferred compensation plans" that can include salary deferral plans, bonus plans, certain severance agreements, below-market stock options and stock appreciation rights (SARs) and "change of control" agreements, as well as more traditional deferred compensation plans. The 2004 law imposed significant new requirements on such plans with respect to the timing of elections to defer compensation, changes to any such elections, and the timing and form of payouts. The penalties for violating Section 409A are severe: the affected employee is subject to tax on all amounts deferred under the non-compliant plan, and must pay interest on the tax "underpayment" as well as a 20% penalty tax.

Although the final regulations follow the regulations proposed in October 2005 in many respects, they also include many notable changes. The most important changes are summarized in this Alert. For a more detailed overview of the Section 409A requirements, please see our article entitled *Congress Rewrites the Rules on Deferred Compensation Plans*.

Documentation Requirements

The final regulations require that the material terms of a covered deferred compensation plan be set forth in a written plan or agreement **no later than December 31, 2007**. The required plan document must identify or describe: the amount of compensation that is to be deferred (or a formula to determine the deferred amount), the procedures for making deferral elections, the timing and form of payouts, and the special "six month rule" for payments to certain key employee (see "Severance Agreements and Plans - Payments to Specified Employees", page 3).

Severance Agreements and Plans

The impact of Section 409A on severance agreements and plans has been a troubling issue since the law was passed. The final regulations changes with respect to severance pay are generally favorable to employers and employees.

Covered Plans and Agreements

The final regulations expand the category of severance agreements and plans that are exempted from Section 409A. For example, the final regulations provide that an agreement that pays severance to an executive who resigns for "good reason" can qualify for exemption from Section 409A. (The proposed regulations did not permit this type of severance benefit to qualify for exemption.) The events which constitute "good reason" for resignation generally must be stated in the agreement, and must be limited to circumstances – such as a material diminution of the employee's duties, authority or salary -- that are effectively equivalent to an involuntary separation.

In addition, the final regulations make it easier to utilize the exemption for severance payable no later than the end of the second year after an involuntary separation, in an amount not exceeding two times the employee's compensation (or \$450,000, if less). The final regulations provide that this provision can be used to exempt separation pay up to the dollar limit, even if the total severance payable exceeds this amount.

The final regulations also include guidance on what constitutes an "involuntary separation" for purposes of this exemption.

Reimbursement Benefits

The final regulations clarify and improve the rules that govern severance benefits in the form of reimbursement of certain expenses (such as moving or outplacement expense). For example, the final regulations confirm that severance benefits that are otherwise non-taxable – like continued health insurance coverage – are not subject to Section 409A. The final regulations also provide that expenses that could have been deducted if the employee had paid them directly can be reimbursed upon separation from service – whether voluntary or involuntary – without regard to Section 409A.

Payments to Specified Employees

Section 409A provides that deferred compensation payable upon separation from service to certain "specified employees" must be delayed for 6 months after separation. In general, "specified employees" are key employees of publicly traded companies. The proposed regulations' rules for determining an employer's "specified employees" were not totally clear, creating the risk that an employer would inadvertently fail to delay separation payments to a specified employee and thereby violate Section 409A. The final regulations modify these rules, generally in ways that should be useful to employers.

Combining Exemptions

Lastly, the final regulations state that different exemptions from Section 409A coverage can be combined. For example, the exemption for involuntary severance pay up to two times pay, the exemption for reimbursement benefits, and the exemption for certain limited severance payments, could be applied in the aggregate so as to exempt different portions of a large severance package.

Stock Options and Other Stock Rights

With respect to stock options and other stock rights, the final regulations include several provisions that should be beneficial to employers and employees.

Expanded Definition of "Service Recipient Stock"

Non-statutory stock options (NSOs) and stock appreciation rights (SARs) are potentially subject to Section 409A. (Incentive stock options are generally exempt, although the modification of an ISO may implicate Section 409A.) The proposed regulations exempted most NSOs and SARs if the exercise price equaled or exceeded the fair market value of the stock as of the grant date. However, the exemption only applied if the option or right was granted with respect to certain classes of common stock of the employer or the employer's parent or subsidiary – so called "service recipient stock". The final regulations significantly broaden this exemption definition: "service recipient stock" now can be issued by any corporation in a chain of corporations ending with the direct employer. Furthermore, a broader category of common stock qualifies for the exemption.

Extension of exercise periods for options and SARs

Under Section 409A an extension of the exercise period of a stock option or stock right can trigger a violation. The proposed regulations provided a very limited exception to this rule, permitting an extension to the end of the year in which the option would otherwise have expired or, if later, 2½ months after the option would otherwise have expired. The final regulations have expanded this



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ADMISSIONS INFORMATION

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exception dramatically: an NSO or SAR can now be extended until the earlier of 10 years after the grant date or the end of the original term of the option. The final regulations also provide that "underwater" stock options can be extended indefinitely. These new rules should be very useful in negotiating severance arrangements with employees who hold unexercised stock options that would otherwise expire shortly after separation.

Valuation Issues

In order to be exempt from Section 409A, the exercise price of a stock option or SAR must equal or exceed the fair market value of the stock at the grant date; thus, it is important to accurately value the underlying stock when granting an option or SAR that is intended to be exempt. The final regulations generally retain the rules set forth in the proposed regulations for determining when stock has been properly valued, although some "safe harbors" and other clarifications have been added.

The general rule under the proposed regulations - that stock must be valued through the "reasonable application of a reasonable valuation method" - has been retained; the IRS declined to establish a more lenient "good faith" standard. However, the final regulations permit different valuation methods to be used for different purposes; for example, one method could be used to set the exercise price and a different method could be used for determining fair market value at the time of exercise. Furthermore, the rules permitting a more lenient standard for valuations of start-up company stock have been relaxed.

Other Changes

The final regulations contain many other changes to the applicable rules, including changes to the "short term deferral" exception, the plan aggregation rules, and the rules for determining whether an employee who continues to provide services to the employer has had a "separation from service".

If you have any questions or would like more information regarding Section 409A and stock rights please contact Robert W. Patterson at rpatterson@jaeckle.com or 716.843.3910 or Michele O. Heffernan at mheffernan@jaeckle.com or 716.843.3850.



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