



Benefits Alert

Legal developments affecting employee benefits

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IRS issues final regulations on Section 409A

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After much anticipation and numerous delays, the IRS has issued final regulations on Section 409A. The regulations and preamble, which run almost 400 pages in length and become effective January 1, 2008, provide helpful guidance to taxpayers. Since Section 409A became effective on January 1, 2005, taxpayers have been expected to operate their nonqualified deferred compensation plans in good faith compliance with Section 409A, but the IRS has not required taxpayers to actually amend their plans until final guidance was issued. Now that the final regulations have been issued, the clock starts ticking for taxpayers to revise their deferred compensation plans. Taxpayers have until December 31, 2007, to amend their plans to bring them into compliance with the new rules. So, if you have not yet brought yourself to revising your plans, it is time to do so.

Overview

Section 409A sets forth special tax rules for nonqualified deferred compensation plans. The final Treasury regulations slightly expand the already broad definition of what constitutes deferred compensation, set forth under the proposed regulations. Under this definition, a plan provides for the deferral of compensation if an employee has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the employee in a later year. In addition to employees, in some instances, Section 409A can apply to other service providers, such as directors, independent contractors, consultants, and even management companies.

In brief, the Section 409A rules:

- limit the flexibility in the timing of elections to defer compensation;
- restrict distributions while employed to fixed dates, certain changes of control, or extreme financial hardship;

- prohibit accelerated distributions of deferred compensation;
- prevent key employees of public companies from receiving deferred compensation due to severance from service until six months after such severance; and
- prevent deferrals of distribution dates or changes in the form of payment unless made at least one year in advance of the scheduled distribution date and the new distribution date is at least five years after the prior distribution date.

If these rules are not followed, a participant is immediately taxed on the value of his/her deferred compensation once it is no longer subject to a substantial risk of forfeiture. Additionally, the participant will have to pay a 20-percent excise tax on the amount that is included in his/her income, as well as an interest penalty. The interest penalty is calculated at the IRS underpayment rate plus 1 percent from the date the amount was deferred, or if later, the date it was no longer subject to a substantial risk of forfeiture.

The final regulations

For the most part, the final regulations follow the proposed regulations. However, there are some important exceptions where the IRS has revised troublesome provisions. Important new provisions in the final regulations include the following:

Extension of an option's exercise period. Generally, options granted with a fair-market-value option price are exempt from Section 409A's requirements. Under the proposed regulations, an employer could get itself into trouble when engaging in some common stock-option practices. For example, the exercise period for many options ends shortly after an employee leaves an employer. Under the proposed regulations, if an employer extended the exercise period beyond the later of the end of the calendar year or two-and-one-half months before the option's exercise period would have otherwise expired, the option would become subject to Section 409A, with significant adverse tax consequences. Under the final regulations, an employer can extend an option's exercise period through the earlier of (i) the end of the option's expiration date, or (ii) 10 years from the date of grant. This is helpful relief because many employers had grown accustomed to allowing certain employees to exercise their options for periods beyond the option's normal post-termination exercise period in connection with severance, salary continuation, retirement, and other special agreements, but within the option's expiration date. This practice is no longer a problem under Section 409A.

Termination for Good Reason. Like the proposed regulations, the final regulations include provisions that exclude certain forms of separation pay triggered by an involuntary separation from service as exempt from Section 409A's requirements. The proposed regulations left open the issue as to whether an employee could take advantage of these rules if the employee left for "good reason." This was an important open issue because many executive employment agreements permit an executive to quit and receive severance pay if the executive quits for good reason. The IRS has explained when a termination for good reason will be treated as an involuntary termination and provides a termination-for-good-reason safe harbor. Under the safe harbor, the following requirements must be satisfied for an employee who quits for good reason to be treated as having incurred an involuntary separation from service: (i) the employee must separate from service within one year following the initial existence of the good reason condition; (ii) the amount, time, and form of payment upon a voluntary separation from service for good reason must be identical to the amount, time, and form of payment

upon an involuntary separation from service; (iii) the employee must be required to provide notice of the existence of the good reason condition within 90 days of its initial existence, and the employer must be provided a period of at least 30 days during which it may remedy the good reason condition; and (iv) the good reason condition must be due to 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; a material diminution in the budget over which the employee retains authority; a material change in geographic location at which the employee must perform the services; or any other action or inaction that constitutes a material breach of the terms of the employee's employment agreement.

Separation from service. The final regulations have simplified the definition of when an individual has separated from service. In drafting this definition, the Treasury Department was concerned that employers and employees may collude in when an employee will be treated as separating from service. Therefore, the regulations provide that whether an employee has terminated is determined based on all of the facts and circumstances. Generally, a termination will be deemed to occur if the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or the full period of services to the employer, if the employee has been providing services to the employer for less than 36 months).

Severance benefits. Employment agreements, change-in-control agreements, and severance plans frequently include common benefits that raised issues under Section 409A that were not fully addressed in the proposed regulations. Examples include Section 280G tax "gross-up" payments, indemnification rights, expense reimbursements, and in-kind benefits. The final regulations address how these common benefits should be analyzed under Section 409A, and how the agreements that include such benefits need to be structured to comply with Section 409A requirements.

The above is just a sampling of some of the new provisions included in the final regulations. We will provide additional guidance on the finalized regulations in future communications.

What to do next

Many employers have delayed amending their plans until Treasury issued final guidance on Section 409A. *Now that the guidance has been issued, it is time for employers to thoroughly review their plans and implement action plans to finish this task before the end of the year.* Accordingly, we strongly encourage employers to take the following actions:

- identify all deferral arrangements subject to the new law including, potentially, bonus plans, employment agreements, earn-outs, and severance arrangements;
- develop an action plan to bring plans into compliance with the final regulations;
- ensure plans are operating in good faith compliance with Section 409A;
- develop communications materials to explain the final rules to participants;

- consider what design changes are appropriate in light of the final rules; and
- amend existing plans to comply with the final rules.

The final regulations are complicated and many of the choices for implementing the final rules will involve thoughtful consideration and politically sensitive decisions. Moreover, many of these decisions will require action by boards of directors. Thus, waiting until the end of the year to address these issues could risk missing the IRS deadline.

In this environment, we encourage you to consult your benefits attorneys if you have any questions or concerns. For more information on this issue or any other benefits law matter, please contact the below or your regular Nixon Peabody attorney:

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