



Treasury and IRS Issue Proposed Regulations under Section 409A — Severance Pay, Performance-Based Compensation and Distributions

October 12, 2005

As we reported in two previous LawFlashes, Treasury and the IRS recently issued proposed regulations under section 409A of the Internal Revenue Code, as amended (the Code), which provide guidance on nonqualified deferred compensation arrangements. Our first LawFlash enumerated actions that plan sponsors and participants need to take before December 31, 2005. Our second LawFlash discussed implications of the proposed regulations on equity compensation arrangements. This third LawFlash highlights the rules with respect to severance pay, performance-based compensation, 401(k) wrap plans and other deferred compensation plans tied to a qualified plan, distributions, and termination of nonqualified deferred compensation plans.

Separation Pay Arrangements

- Under the proposed regulations, separation pay arrangements (i.e., a plan or agreement that provides payment to a service provider conditioned upon termination of services) may constitute deferred compensation under section 409A. A severance pay arrangement will not be considered deferred compensation under section 409A if (1) the arrangement provides severance pay upon involuntary termination, (2) the payment does not exceed the lesser of two times the service provider's annual compensation or two times the compensation limit applicable to qualified plans under section 401(a)(17) of the Code (i.e., \$210,000 for 2005) and (3) payments are completed by the end of the second calendar year following termination. *Comment: While this exception is generally helpful, as a result of these limitations many executive severance arrangements will be subject to section 409A.*
- This general exemption from section 409A does not apply to payments upon a separation from services for "good reason." *Comment: Inclusion of a "good reason" termination provision should not cause otherwise exempted severance pay that is paid as a result of an involuntary termination to be subject to Section 409A.*
- Where separation payments that are subject to section 409A are the subject of bona fide arm's-length negotiations at the time of an involuntary termination, the service provider may make an initial deferral election as to the time and form of payment up to the date on which the service provider obtains a legally binding right to the payment.

- For plan aggregation purposes, the proposed regulations add a separate type of plan for separation pay arrangements. Accordingly, separation pay plans are a separate type of plan from account balance plans, non-account balance plans and equity-based plans. Inadvertent violations of section 409A by separation pay plans will not affect other deferred compensation plans.
- The proposed regulations provide a limited exclusion from section 409A for certain expense reimbursement arrangements if the expenses are paid by the end of the second calendar year following the year in which the termination occurs. The expenses that can be reimbursed under this rule include nontaxable expenses, deductible business expenses, outplacement services, moving expenses, certain medical expenses and expenses that do not exceed \$5,000 in the aggregate in any year.
- Severance pay arrangements may be structured to meet the short-term deferral rule described in IRS Notice 2005-1 by providing for full payment of severance benefits no later than 2½ months after the end of the year in which the severance benefits cease to be subject to a substantial risk of forfeiture. Severance benefits that are paid within the short-term deferral period are not subject to section 409A.

Comment: All severance plans and arrangements, including employment agreements and change of control agreements, should be reviewed and probably will have to be amended either to comply with section 409A or to meet an applicable exception.

Performance-Based Compensation

- Under IRS Notice 2005-1, a service provider may elect to defer certain performance-based compensation as late as six months before the end of the performance period. Under the proposed regulations, performance-based compensation is defined as compensation that is contingent on the satisfaction of pre-established organizational or individual performance criteria.
- Performance-based compensation may be based on one or more subjective performance criteria, as long as the applicable criterion relates to the performance of a particular service provider, a group of service providers or a business unit.
- Performance criteria may be established as late as 90 days after the commencement of the period of service to which the criteria relate, as long as the outcome is not substantially certain at the time the criteria are established. Initial deferral elections with respect to performance-based compensation may be made as late as six months before the end of the performance period, as long as the amount is not readily ascertainable and the service provider's right to receive the amount is not substantially certain.
- Reversing a position initially taken in IRS Notice 2005-1, these regulations permit performance-based compensation to be based solely upon an increase in the value of the stock of the service recipient after the date of grant.

- As a general matter, any performance-based plan that meets the requirements of section 162(m) of the Code should qualify under this six-month rule.

SERPs and 401(k) Wrap Plans

- Qualified plans may be established, amended and operated under the rules governing qualified plans without causing the linked nonqualified plans to violate section 409A.
- The proposed regulations allow a service provider to change a deferral election under a 401(k) plan without causing the nonqualified plan to violate section 409A. This relief is available only to the extent that the service provider's actions under the 401(k) plan do not result in an increase in the amounts deferred under the nonqualified plan in excess of the deferral limit under section 402(g) of the Code (i.e., for 2006, \$15,000).

Short-Term Deferrals

- The proposed regulations generally retain the short-term deferral rule described in IRS Notice 2005-1. The proposed regulations do not require that a short-term deferral plan specify a payment date. However, if the plan does not specify a payment date and payment is not made within the 2½-month grace period, the plan will be subject to section 409A.
- If a payment date is specified in the plan and payment is not made within the 2½-month grace period, the rules (described below) permitting payment to be made in the same calendar year as the fixed payment date will apply, and no violation of section 409A will be deemed to have occurred. *Comment: This rule will likely require amendment of bonus and similar plans to specify a payment date.*

Distribution of Deferred Compensation

- Section 409A requires payments to be made at a fixed date or under a fixed schedule, or upon separation from service, death, disability, a change of control of a corporation or an unforeseeable emergency. Under the proposed regulations, a plan will satisfy these requirements if, at the time of deferral, the plan specifies payment dates that are objectively determinable.
- The proposed regulations include rules of administrative convenience. If a payment date is specified in a plan subject to section 409A, payment may be made by the later of the first date on which it is administratively possible to make the payment or the end of the calendar year containing the designated date.
- Under the proposed regulations, a plan may delay payment under limited circumstances, including delays to preserve deductions under section 162(m) of the Code or delays to avoid violation of securities laws, loan covenants or other contractual terms.
- Section 409A rules regarding permissible distributions upon a change of control of a corporation may be applied by analogy to partnerships.

- Earn-outs paid as a result of a change of control may be treated as paid in a manner complying with section 409A if the payments are made on the same terms as payments to shareholders generally pursuant to the change of control and the payments are made no later than five years after the transaction. *Comment: As a practical matter, there are still a number of open issues with respect to earn-outs, escrows and indemnities. As a result, parties should proceed with caution in this area.*

Termination of Deferred Compensation Plans

The proposed regulations permit a service recipient to terminate its deferred compensation plans in only three circumstances:

- Within 12 months of a corporate dissolution or bankruptcy.
- Within 30 days before or 12 months following a change of control.
- Pursuant to the service recipient's exercise of discretion under the plan, provided (1) all plans of the same type are terminated with respect to all participants, (2) no payments (other than ordinary course payments that would have been made had the plan not terminated) are made within 12 months of the plan termination, (3) all payments are made within 24 months of the plan termination, and (4) no new similar plan is adopted for five years.

If you have any questions or would like further information on the proposed regulations under section 409A, please contact any one of the following Morgan Lewis attorneys:

Chicago

Brian D. Hector	312.324.1160	bhector@morganlewis.com
-----------------	--------------	--

Dallas

Riva T. Johnson	214.466.4107	riva.johnson@morganlewis.com
Erin Turley	214.466.4108	eturley@morganlewis.com

New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com
Gary S. Rothstein	212.309.6360	grothstein@morganlewis.com

Palo Alto

S. James DiBernardo	650.843.7560	jdibernardo@morganlewis.com
Zaitun Poonja	650.843.7540	zpoonja@morganlewis.com

Philadelphia

Robert L. Abramowitz	215.963.4811	rabramowitz@morganlewis.com
Brian J. Dougherty	215.963.4833	bdougherty@morganlewis.com
I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Robert J. Lichtenstein	215.963.5726	rlichtenstein@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com

Joseph E. Ronan	215.963.5793	jronan@morganlewis.com
Steven D. Spencer	215.963.5714	sspencer@morganlewis.com
Mims Maynard Zabriskie	215.963.5036	mzabriskie@morganlewis.com

Pittsburgh

John G. Ferreira	412.560.3350	jferreira@morganlewis.com
R. Randall Tracht	412.560.3352	rtracht@morganlewis.com

San Francisco

Mark H. Boxer	415.442.1695	mboxer@morganlewis.com
Eva P. McComas	415.442.1249	emccomas@morganlewis.com

Washington, D.C.

Althea R. Day	202.739.5366	aday@morganlewis.com
Gregory L. Needles	202.739.5448	gneedles@morganlewis.com

About Morgan, Lewis & Bockius LLP

Morgan Lewis is a global law firm with more than 1,200 lawyers in 19 offices located in Philadelphia, Washington, D.C., New York, Los Angeles, San Francisco, Miami, Pittsburgh, Princeton, Chicago, Palo Alto, Dallas, Harrisburg, Irvine, Boston, London, Paris, Brussels, Frankfurt and Tokyo. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.