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together

## Final 409A Regulations: An Overview



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May 15 & 16, 2007

# Final 409A Regulations

- Issued April 10, 2007
- Regulations incorporate and expand on guidance provided under the proposed regulations issued in September 2005
- Deadline for plan sponsors to amend their plan documents to conform to 409A requirements remains December 31, 2007

## Final 409A Regulations

- Employees may amend payment elections (for payments not otherwise payable in 2007) by 12/31/07 under existing transition guidance
- No further guidance on income inclusion, reporting and withholding
- Final regulations are effective 1/1/08 but may be relied upon in the interim. Employers may also rely on the proposed regulations, IRS Notices and good faith interpretations of the statute before 1/1/08

# Section 409A Areas of Concern

- Deferred compensation plans
  - Traditional plans
  - Wrap plans
  - SERPs
- Severance agreements
  - Cash severance
  - Benefit continuation
- Employment agreements

# Section 409A Areas of Concern

- Change in control
  - Severance
  - Gross-up
- Equity compensation plans
- Transactions
  - Earnouts/escrows
  - Deal bonuses

# Highlights of Final Regulations

- Equity Compensation:
  - Can extend the exercise period of an option or SAR through the end of the original option term (not to exceed 10 years) without violating section 409A
  - Underwater options and SARs can be extended and will be treated as a new grant

# Highlights of Final Regulations

- Equity Compensation:
  - Can use any common stock of a service recipient company or its parent or subsidiary in the controlled group for a stock option or SAR; provided that the common stock does not include payment preferences (other than a liquidation preference)
  - Service recipient can include parent entities where there is as little as 20% ownership interest if there is a legitimate (non tax related) business reason to do so

# Highlights of Final Regulations

- Equity Compensation:
  - The regulations continue (with slight modification) the three presumptive safe harbors with respect to determining fair market value of stock of privately held companies:
    - Independent appraisal
    - Section 83 non-lapse formula
    - Valuation by a qualified person for a start up company

# Highlights of Final Regulations

- Short-Term Deferrals:
  - The regulations continue to exclude from section 409A payments made within 2½ months of the close of the year in which the payments vest
  - If the plan intends to rely on the short-term deferral exception, the terms of the plan must provide for payment within the short-term deferral period

# Highlights of Final Regulations

- Severance:
  - The regulations clarify the exception for severance plans that provide for payments in the event of involuntary termination (or window program)
  - Exception applies to the extent that severance pay does not exceed 2 times pay (up to 2 times the 401(a)(17) limit – currently  $\$225,000 \times 2 = \$450,000$ )
    - Separation pay up to the limit is excepted, with amounts over the limit subject to section 409A (unless another exception applies)

# Highlights of Final Regulations

- **Severance:**
  - Six month delay rule still applies to key employees, but can minimize impact by properly structuring agreement
  - Employment agreements can contain certain “good reason” provisions without adversely affecting ability to use the separation pay exception or the short-term deferral exception to section 409A
  - The regulations define good reason under a facts and circumstance test and include a safe harbor for payments meeting certain criteria

# Highlights of Final Regulations

- Severance:
  - Good reason safe harbor
    - Payments triggered by material diminution in duties, compensation or authority
    - Separation from service no later than two years following the good reason event
    - Employer has the opportunity to cure the good reason condition after it receives notice of the condition from the employee
  - If the good reason definition meets the requirements of section 409A, the termination is treated as an involuntary termination

# Highlights of Final Regulations

- Severance:
  - *Example:*
    - Severance package for key employee on involuntary termination is \$2.4 million
    - Date of termination is 12/31/07
    - Employer wants to pay in installments over two years (\$100,000 per month)
    - Employee wants to minimize effect of six-month delay. Six month delay period ends 6/30/08

# Highlights of Final Regulations

- Severance
  - **Result (Alternative 1):**
    - \$450,000 (2 times 401(a)(17) limit) may be paid in installments over two years (severance pay exception).
    - The remaining \$1,950,000 can be paid in monthly installments after six months from separation from service (commencing 7/1/08) (amount subject to 409A, so six-month delay).

# Highlights of Final Regulations

- Severance:
  - Result (Alternative 2):
    - \$450,000 (2 times 401(a)(17) limit) may be paid in installments of \$100,000 per month for 4½ months (severance pay exception)
    - The remainder can be paid monthly over the balance of the two years (\$100,000 per month), as follows:
      - \$150,000 lump sum payment before 3/15/08 within the short-term deferral rule (representing payment of the balance of \$100,000 per month for the first six months)

# Highlights of Final Regulations

- Severance:
  - Result (Alternative 2):
    - The remaining \$1,800,000 payable over 18 months commencing 7/1/08 (amount subject to 409A, so subject to six-month delay)
    - The agreement needs to state that each payment is treated as a separate payment (not as a stream of payments) under 409A

# Highlights of Final Regulations

- Distribution Requirements:
  - Reimbursements
    - Exception from 409A for reimbursed business expenses, outplacement expenses and moving expenses, if expenses are incurred by the end of the second year following the year in which the separation from service occurs and paid by the end of the third year

# Highlights of Final Regulations

- **Reimbursements**

- Reimbursement of medical expenses can continue through the COBRA continuation period and will be exempt from 409A. Reimbursements after this period are subject to 409A
- Exception for a reimbursement amount up to the 402(g) limit (currently \$15,500)
- Other reimbursements and in kind benefits must comply with section 409A

# Highlights of Final Regulations

- **Tax gross ups**
  - Tax gross ups will be treated as paid at a specified time or on a fixed schedule if the plan provides that payment will be made (and the payment is made) by the end of the taxable year next following the taxable year in which the taxes are paid
- **The regulations clarify the circumstances under which the timing of distributions can be based on an objective formula**

# Highlights of Final Regulations

- Separation from Service:
  - The regulations provide more flexibility in determining whether there has been a separation from service
    - No exception for “payroll continuation”
    - Treat employees and independent contractors as subject to the same rules
    - A separation from service occurs where the level of services is reduced to a level expected to be no more than 20% of the level of services provided during the preceding 36-month period

# Highlights of Final Regulations

- Separation from Service:
  - The regulations allow a plan to define a permanent reduction in services (at least 50%) as a separation from service for purposes of making distributions from a NQDC plan
  - In the context of an asset sale, the regulations permit an employee whose employer is no longer part of the controlled group but who continues to provide the same services to be treated as having not separated from service (“same desk rule”)

# Highlights of Final Regulations

- “Linked Plans” and Foreign Arrangements:
  - The final regulations provide additional guidance relating to the application of section 409A to (1) nonqualified plans “linked” to qualified plans and (2) nonresident aliens and foreign deferred compensation plans
- The regulations expand the types of plans subject to the plan aggregation rules

# Highlights of Final Regulations

- Split-Dollar Arrangements:
  - IRS Notice 2007-34 provides guidance regarding the application of section 409A to split dollar arrangements

# Highlights of Final Regulations

- Split-Dollar Arrangements:
  - In general, Notice 2007-34 provides that split dollar arrangements which are subject to section 409A may be modified to comply with section 409A without having the modification treated as a “material modification” for purposes of causing the arrangement to be subject to the final split dollar regulations
  - The notice also provides guidance as to how 409A may apply to a split dollar arrangement

# Highlights of Final Regulations

- Plan Terms:
  - Each NQDC plan must be in writing and must reflect the requirements of section 409A
    - At minimum, the written document must include the amount to be paid, payment schedule, payment triggering events and the conditions for elections under the plan
    - If plan sponsor is a public company, plan must include the six-month delay requirement (and must describe with specificity how key employees are to be determined)

# Highlights of Final Regulations

- Plan Terms:
  - Plan sponsors may not rely on general “savings clauses” in documents. Plan documents must include appropriate 409A terms
  - All plans and arrangements providing deferred compensation must be amended to comply with section 409A by 12/31/07
    - Plan sponsors should inventory their arrangements and consider design alternatives to bring arrangements into compliance with 409A

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