

IRS Issues Final Regulations under Section 409A: Short-Term Deferrals, Severance Pay, Performance-Based Compensation, and Distributions

April 30, 2007

On April 10, 2007, the IRS issued final regulations (Final Regulations) relating to nonqualified deferred compensation plans under section 409A of the Internal Revenue Code, as amended (the Code). Our first LawFlash on this issue, released on April 13, 2007, set forth the highlights of the Final Regulations. (To view our April 13 LawFlash, please visit: http://www.morganlewis.com/pubs/EB_CodeSection409A_LF_13apr07.pdf.)

This second 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. We will release a third LawFlash addressing issues raised in the Final Regulations in the area of equity compensation plans. We also anticipate issuing a LawFlash on the effects of section 409A on split-dollar life insurance policies.

Background

- Section 409A, generally effective for compensation deferred and vested on or after January 1, 2005, provides that amounts deferred by an employee under a “nonqualified deferred compensation plan” are included in income when no longer subject to a substantial risk of forfeiture and are subject to a 20% tax, unless the plan complies with specific timing requirements for deferral elections and distributions.
- Although section 409A refers to deferral of compensation paid by “service recipients” to “service providers” (a term that includes employees, independent contractors, and personal service corporations), for purposes of this LawFlash, we refer to service recipients as *employers* and service providers as *employees*.

Severance/Separation Pay Arrangements

- The Final Regulations provide a number of helpful exceptions and exclusions in the area of severance and separation pay that allow separation pay arrangements to be structured to avoid application of section 409A (and for key employees, the six-month delay [see below]). *However, it is important to note that all severance and separation plans and agreements,*

including employment agreements that provide for separation payments, must be reviewed and revised (to the extent necessary) no later than December 31, 2007 in order to comply with the requirements of section 409A.

- Among the restrictions that section 409A imposes on the timing of distributions is a rule that restricts for a period of six months following a separation from service any distribution payable to “key employees” of publicly traded companies, where the payment is triggered by the separation. For purposes of this rule, key employees are generally the company’s 50 most highly compensated officers. The Final Regulations provide for certain default definitions and rules for identifying key employees.
- Under the Final Regulations, a severance pay arrangement will not be considered deferred compensation under section 409A (1) if payment is made only upon involuntary termination (or termination for good reason, as described below), (2) to the extent that the payments do not exceed the lesser of two times the employee’s annual compensation or two times the compensation limit applicable to qualified plans under section 401(a)(17) of the Code (i.e., \$225,000 for 2007, so the severance “cap” under section 409A is \$450,000 for 2007), and (3) if payments are completed by the end of the second calendar year following termination.

Note: If the amounts payable upon a separation exceed the dollar limitation described in (2) above, only the excess amount is treated as deferred compensation under section 409A.

- The Final Regulations clarify exclusions from section 409A for certain (1) bona fide collectively bargained arrangements, (2) payments under a window program or upon an involuntary separation, (3) foreign separation plans, (4) reimbursement arrangements, and (5) payments that are less than the annual limit for elective deferrals under section 402(g) of the Code (currently \$15,500).
- In a major revision of the proposed regulations, the general exemption from section 409A for severance payments triggered by an involuntary termination will also apply to payments upon a separation from service for “good reason.” A plan’s use of a good reason condition must not be for the principal purpose of avoiding section 409A. A good reason condition must require actions by the employer resulting in a material adverse change in the employment relationship. While this is primarily a facts-and-circumstances analysis, the Final Regulations provide a safe harbor as to what will constitute sufficient good reason. For the good reason safe harbor to apply, a plan must define separation for good reason to require actions taken by the employer resulting in a material adverse change in the duties to be performed, the conditions under which the duties are to be performed, or the compensation to be received. In addition, the employee must give notice of the good reason condition, and the employer must be provided with a cure period.

If the good reason condition is treated as resulting in an involuntary termination, then a severance payment could constitute a short-term deferral (if it otherwise meets the short-term deferral rules described below under Short-Term Deferrals), and the employee could receive the payment immediately upon termination. If the good reason condition is not treated as resulting in an involuntary termination, then the payment would not constitute an exempt short-term

deferral, and, if the employee is a key employee, the arrangement would be required to provide for a six-month payment delay.

- Severance pay arrangements may be structured to meet the short-term deferral rule 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 generally not subject to section 409A. Where an arrangement provides for installment payments, if each installment is designated as a separate payment, then any installment that is required to be paid before the 2½-month deadline will not be subject to section 409A (and will also not be subject to the six-month delay for key employees), although subsequent payments under the same arrangement will be. However, amounts accruing under a supplemental executive retirement plan (SERP) or other long-term plan in the year of a participant's separation from service will remain subject to section 409A and the six-month delay requirement for key employees.
- A severance pay arrangement is automatically subject to section 409A if the arrangement specifies a payment date or payment event that will or may occur after the 2½-month short-term deferral deadline, even if the payment is actually made within the 2½-month time period. The Final Regulations make it clear that where a plan has a specified payment date or event, that date or event must not occur later than the end of the short-term deferral period, in order to avoid application of section 409A.
- Where separation payments that are subject to section 409A are the subject of bona fide arm's-length negotiations, the election as to the time and form of payment may be made when the rights to the severance pay become vested, which is typically at the time of termination.
- The Final Regulations treat any payment amount that acts as a substitute for, or replacement of, amounts payable under a separate deferred compensation arrangement as a payment of deferred compensation under that separate plan and not as separation pay.
- As under the proposed regulations, certain plans are required to be aggregated for purposes of section 409A. The Final Regulations increase the number of plan types subject to aggregation from four to nine. For these purposes, separation pay plans are a separate type of plan from account balance plans, nonaccount balance plans, and equity-based plans. Violations of section 409A with respect to one type of plan (such as a separation pay plan) will not affect other types of deferred compensation plans.

Short-Term Deferrals

- The Final Regulations generally retain the short-term deferral rule described in the proposed regulations. The Final 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. Limited exceptions are provided for failures to make payment by the appropriate deadline: for example, due to unforeseeable administrative issues or loss of a corporate deduction under section 162(m) of the Code, or if the payment would jeopardize the employer's ongoing concern as a business.

- If a payment date is specified in the plan and payment is not made within the 2½-month grace period, the rules (described below under Distribution of Deferred Compensation) 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. *This rule will likely require amendment of bonus and similar plans to specify a payment date.*

Performance-Based Compensation

- As under the proposed regulations, an employee may elect to defer certain performance-based compensation as late as six months before the end of the performance period. Under the Final Regulations, performance-based compensation is defined as compensation that is contingent on the satisfaction of preestablished organizational or individual performance criteria relating to a performance period of at least 12 consecutive months.
- The Final Regulations clarify that a portion of an award can qualify as performance-based, even if another portion of the award does not qualify.
- 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 employee, a group of employees, 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 readily ascertainable 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 employee's right to receive the amount is not substantially certain. If any amounts are readily ascertainable before the election is made, the election can only apply to future amounts that are not readily ascertainable. The employee does not have to be employed throughout the entire performance period—only through the date that the initial deferral election is made.
- 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, provided that the performance period is at least 12 months.
- Automatic payment upon death, disability, or change in control does not taint the arrangement as performance based, provided such payments are not based on termination without cause or for good reason.
- Equity-based compensation is performance-based compensation if it is based solely on an increase in the value of the employer or a share of service recipient stock after the date of a grant or award. Compensation payable for a service period that is equal to the value of a predetermined number of shares of stock, and is variable only to the extent that the value of such shares appreciates or depreciates, generally will not be performance-based compensation. If the right to such compensation, however, is subject to a performance-based vesting requirement, such compensation may be performance-based compensation.

Reimbursement and Fringe Benefit Plans

- The Final Regulations clarify that the right to receive a benefit that is excludable from income is not deferred compensation subject to section 409A.
- The period that taxable reimbursements of medical expenses can be provided without being considered deferred compensation has been extended to the COBRA period.
- The exemption for reimbursement of postseparation benefits generally applies only to eligible expenses incurred before the end of the second year following the year of separation and reimbursed by the end of the third year.

401(k) Wrap Plans and SERPs

- The Final Regulations allow an employee to change a deferral election under a 401(k) plan without causing a linked nonqualified deferred compensation plan to violate section 409A. This relief is available only to the extent that the employee's actions or inactions under the 401(k) plan do not result in an increase or decrease in the amounts deferred under all of the nonqualified plans in which the employee participates in excess of the elective deferral limit under section 402(g) of the Code (which also includes the catch-up contribution limit, if applicable). For 2007, the elective deferral limit is \$15,500, and the catch-up contribution limit is \$5,000.
- No special provisions are included under the Final Regulations for SERPs. SERPs are subject to the same distribution rules as other deferred compensation plans (see Distributions of Deferred Compensation). *All SERP participants must make distribution elections that comply with section 409A by December 31, 2007.*

Distribution of Deferred Compensation

- Generally, an initial election to defer compensation must be made by the close of the year preceding the year in which compensation subject to the deferral election is earned. The election must include the time and form of payment and must be irrevocable as of the deadline for making the election. Any subsequent election to change the time or form of a distribution generally may not take effect for 12 months and must provide for a new distribution date that is at least five years after the date on which the distribution would have otherwise been made.
- 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 in control of a corporation, or an unforeseeable emergency. Under the Final Regulations, a plan will satisfy these requirements if, at the time of deferral, the plan specifies payment dates that are objectively determinable and nondiscretionary.
- A plan may provide that a payment will be made during a designated period that is objectively determinable and nondiscretionary at the time the payment event occurs if the designated period both begins and ends within one taxable year of the employee or the designated period is not

more than 90 days, and the employee does not have a right to designate the taxable year of the payment (other than an election that complies with the subsequent deferral election rules).

- A plan may generally designate only one time and form of payment upon the occurrence of each of a separation from service, death, disability, change in control, or unforeseeable emergency, provided that a payment upon such occurrences may have an alternative payment schedule if such payment event occurs on or before one specified date (e.g., a lump-sum payment upon a change in control before age 55, but installments upon a change in control on or after age 55).
- With respect to a payment upon a separation from service, a different time and form of payment may be designated under each of the following conditions: (1) a separation from service during a limited period of time not to exceed two years following a change in control; (2) a separation from service before or after a specified date (e.g., the attainment of a specified age), or a separation from service before or after a combination of a specified date and a specified period of service, determined under a predetermined, nondiscretionary, objective formula or pursuant to the method for crediting service under a qualified plan sponsored by the employer; and (3) a separation from service not described in (1) or (2).
- A payment will be treated as made upon the date specified in the plan if the payment is made (1) no earlier than 30 days before the designated date, (2) upon such date, or (3) at a later date within the same taxable year of the employee or, if later, by the 15th day of the third calendar month following the date specified under the plan, provided the employee is not permitted to designate the taxable year of payment.
- The Final Regulations include rules of administrative convenience. If calculation of the amount of the payment is not administratively practicable due to events beyond the control of the employee, the payment may be made during the first taxable year of the employee in which the calculation of the amount is administratively practicable. In addition, if the making of the payment at the date specified under the plan would jeopardize the ability of the employer to continue as a going concern, the payment may be made during the first taxable year of the employee in which the making of the payment would not have such effect.
- Under the Final 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 or other applicable laws.
- A plan providing a right to a tax gross-up payment will be treated as providing for payment at a specified time or on a fixed schedule of payments if the plan provides that payment will be made, and the payment is made, by the end of the employee's taxable year following the year in which the employee remits the related taxes.
- Earn-outs paid as a result of a change in control may be treated as paid in a manner complying with section 409A if the payments are made on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to the change in control and the payments are made no later than five years after the transaction. In addition, earn-outs that are subject to a substantial risk of forfeiture and are payable under the same terms and conditions as payments to shareholders generally may qualify as short-term deferrals under section 409A. *As*

a practical matter, there are still a number of open issues with respect to earn-outs and escrows. As a result, parties should proceed with caution in this area.

Termination of Deferred Compensation Plans

The Final Regulations permit a plan or arrangement to accelerate the time and form of a payment upon termination and liquidation in only three circumstances:

1. Within 12 months of a corporate dissolution or bankruptcy.
2. Within 30 days before or 12 months following a change in control.
3. Termination and liquidation of the plan, provided that (1) the termination and liquidation does not occur proximate to a downturn in the financial health of the employer, (2) all plans of the same type are terminated with respect to all participants, (3) 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, (4) all payments are made within 24 months of the plan termination, and (5) no new similar plan is adopted for three years.

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