

The Final Rules Under Section 409A

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The Final Rules Under Section 409A

Why Comply with 409A?

- Adverse tax consequences for the service provider/employee:
 - Immediate income tax
 - 20% “additional tax”
 - Interest charge
- IRS guidance on how to calculate tax is the next regulation project
 - Announcement 2007-18 provides guidance on application to 409A-noncompliant options/SARs exercised in 2006

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Why Comply with 409A?

What is Subject to Section 409A?

- “Deferred Compensation”
 - Legally binding right to receive a payment in a later year
- Key exceptions
 - Short-term deferral rule
 - Pay within 2-1/2 months after year compensation is no longer subject to a substantial risk of forfeiture (“SROF”) (i.e., requirement to provide future services or a condition relating to purpose of the compensation)
 - This is useful in many contexts (e.g., severance pay may avoid 409A in certain circumstances if this rule applies)

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What is Subject to Section 409A?

What is Subject to Section 409A?

- Other important exceptions
 - Property taxed under section 83
 - Restricted stock
 - Contrast RSUs/phantom stock – subject to 409A if short-term deferral rule does not apply
 - Stock options/SARs (“stock rights”) that satisfy certain requirements
 - Involuntary severance/separation pay that meets specified requirements
 - “Grandfathered” amounts – earned & vested as of 12/31/04
 - Lose grandfathered status if “material modification”

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What is Subject to Section 409A?

What Does Section 409A Require?

- **Section 409A addresses three basic issues if compensation is subject to the rules; the rest is just details:**
 - When an election to defer compensation must be made
 - The circumstances in which payments can be made
 - When payment elections can be changed

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What Does Section 409A Require?

When Deferral Election Must Be Made

- **General rule:** Taxable year before related services commence
- **Special rules:**
 - Performance-based compensation
 - New participants
 - 30 days after eligible, but plan aggregation rules apply
 - “Ad hoc” awards
 - Can elect within 30 days of grant if vesting period is at least 13 months (e.g., RSUs)

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When Deferral Election Must Be Made

When Payment Can Be Made

- Only in the following circumstances
 - Separation from Service
 - 6-month delay for “specified employees”
 - Disability
 - Death
 - Specified time (not specified event)
 - Change in control (specifically defined in the final regulations)
 - Unforeseeable emergency

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When Payment Can Be Made

When Payment Elections Can Be Changed

- Can never accelerate
 - But “alternative” election ok if both events are permitted under 409A (e.g., earlier of change in control or separation from service)
- Can redefer as long as elect one year in advance and additional deferral of at least 5 years
- Special transition rule for 2007: Can change payment elections to accelerate or further defer as long as no money moved into or out of 2007
 - This transition rule goes away on 12/31/07 and will not be renewed

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When Payment Elections Can Be Changed

The Final Regulations

- **Most key changes from the proposed regs relate to the initial question: What is deferred compensation:**
 - Stock Rights
 - Involuntary separation/good reason
- **Some other key changes:**
 - Separation from service
 - Specified employees
 - Plan aggregation rules

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The Final Regulations

Stock Rights

- **Stock options/SARs (“stock rights”) generally are subject to 409A unless:**
 - They are issued with respect to service recipient stock; and
 - The exercise price is at least FMV of the stock on the date of grant.
- **Stock rights subject to 409A will violate 409A in most circumstances**
 - Key exception is if there is a “hard-wired” exercise date



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Stock Rights

Service Recipient Stock

- Proposed regulations received much criticism as too narrow
- Under final rules, includes:
 - Any class of common stock (regardless of whether publicly traded, transferability restrictions, aggregate value or buyback rights)
 - No dividend preferences
 - Liquidation preference ok
 - Only common stock – not preferred stock

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Service Recipient Stock

Service Recipient Stock (cont'd)

- Stock can be of any corporation in a chain of organizations all of which have a controlling interest in another organization, beginning with the parent organization and ending with the organization for which the grantee was providing services as of the date of grant of the stock right.
 - In other words, can go “up the chain” from the actual employer, but not down the chain
- Controlling interest threshold 50%
- Can be as low as 20% if legitimate business criteria (e.g., a former employee transferred to a 20%-owned joint venture or an employee of a 20% JV who is expected to transfer to the entity that granted the stock right)

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Service Recipient Stock (cont'd)

Determining FMV – Public Companies

- Any reasonable method using actual transactions in the stock generally ok
 - Regs specifically provide that FMV may be determined based upon the last sale before or the first sale after the grant, the closing price on the trading day before or the trading day of the grant, or the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant.
- Also can use average over up to 30 days before or after grant
 - However, if use average from before grant date, must have irrevocable commitment to grant before period commences

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Determining FMV – Public Companies

Determining FMV – Private Companies

- **Must be reasonable method**
 - No independent appraisal required
 - Can consider recent arm's length sales
- **Safe harbors for valuation –generally same as proposed regs**
 - Special safe harbor for “illiquid startups” if do not reasonably anticipate at grant date a change in control in the next 90 days or an IPO in the next 180 days

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Determining FMV – Private Companies

Modifications of Stock Rights

- A “modification” of a stock right is considered a new grant
 - Thus, if stock rights are “in the money” as of deemed new grant date, the rights are subject to 409A
- Modification means any change in the terms of the stock right (or change in the terms of the underlying plan) that may provide the grantee with a direct or indirect reduction in the exercise price
 - Applies regardless of whether grantee actually benefits from the change in terms.
 - Shortening vesting period not a modification
 - Also generally not a modification to allow new forms of payment of the exercise price

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Modifications of Stock Rights

Extensions of Stock Rights

- Controversial under proposed regs – any extension (subject to limited exception for short extensions at termination of employment) retroactively subjected the right to 409A
- Final regs provide much more flexibility; following are not considered “extensions”:
 - Extension to the earlier of 10 years from grant or the end of the original maximum term of the stock right
 - Rights not “in the money” as of date of extension
 - Pre-April 10, 2007 extensions

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Extensions of Stock Rights

Stock Rights – Corporate Transactions

- **Generally not a modification if substitute new shares pursuant to a corporate transactions**
 - Similar to ISO rules – in general not an extension if no increase in aggregate spread and ratio test is met
 - Grantee does not have to be an employee as of the date of the substitution

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Stock Rights – Corporate Transactions

Restricted Stock/RSUs

- The issuance of restricted stock will not be subject to Section 409A, regardless of whether the recipient makes a Section 83(b) election with respect to that stock (there is no separation of vesting and taxation)
 - There is an anti-abuse rule, however
- RSUs/Phantom stock will be subject to Section 409A if cash payment in respect of the phantom shares does not fit within the short-term deferral exception

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Restricted Stock/RSUs

Special Rule for RSUs

- RSUs will be subject to Section 409A if the delivery of shares underlying vested units is delayed beyond March 15 of the year following the year of vesting
 - Elective deferral of payment in respect of vested restricted stock units is permissible if the election is made within 30 days of the grant date and the award does not vest until 13 months after the grant date (the “ad hoc” rule)

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Special Rule for RSUs

Severance/Separation Pay

- Under the proposed regs, generally exempt from 409A if payable only in connection with involuntary termination (e.g., without “cause”) and either:
 - Paid entirely during short-term deferral period
 - To the extent no more than the two times the lesser of (i) the employee’s average compensation or (ii) the Code section 401(a)(17) limit for the year (\$225,000 for 2007)
- “Good reason” provisions arguably subjected the arrangement to 409A even if payment was ultimately due to a “without cause” termination
 - Only practical impact was on “specified employees” of public companies – six-month delay in payment of severance

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Severance/Separation Pay

Good Reason

- Final regs include new rules on good reason provisions – treat as payable “only upon involuntary termination” if certain tests met
 - Generally, facts and circumstances test: Is the separation from service effectively an involuntary separation?

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Good Reason

Good Reason Safe Harbor

- Final rules provide a good reason “safe harbor”:
 - Employee must actually terminate employment within a limited period of time (not to exceed two years) following the initial existence of the good reason condition;
 - Amount, time and form of payment must be identical to that available upon a “without cause” termination;
 - Employee must be required to provide notice of the existence of the good reason provision within a period not to exceed 90 days of its initial existence, and the employer must be provided a 30-day “cure” period; and
 - Good reason must consist of one or more of six enumerated conditions arising without the consent of the employee (next slide).

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Good Reason Safe Harbor

Good Reason (cont'd)

- Good Reason “safe harbor” termination provisions:
 - Material diminution in base compensation;
 - Material diminution in authority, duties, or responsibilities;
 - Material diminution in the authority, duties, or responsibilities of the supervisor to whom the employee is required to report (including a change from the board to a corporate officer);
 - Material diminution in the budget over which the employee retains authority;
 - Material change in geographic location at which the employee must perform services; or
 - Any other action or inaction that constitutes a material breach of the terms of an applicable employment agreement.

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Good Reason (cont'd)

Severance Overview – “Compliant” Good Reason Provisions

- Private companies
 - Generally can pay according to terms
 - But, method of payment generally must be “hard-wired”; no choice at time of termination
- Public companies
 - Non-specified employees: same as private company employees
 - Specified employees
 - Can pay in full in lump sum
 - Can use “two times” safe harbor as well if don’t pay in lump sum
 - Severance will be subject to 409A if it does not fall under either of the foregoing. In that event, can pay the safe harbor amount within the six months, but the rest must be delayed for six months

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Severance Overview – “Compliant” Good Reason Provisions

Reimbursements and Fringe Benefits

- **Some are exempt from 409A**
 - Nontaxable benefits
 - Medical during COBRA period
 - One-time exclusion for amounts up to the 402(g) exclusion on elective deferrals (\$15,500 in 2007)
 - Reimbursement of excludable expenses and in-kind benefits incurred within a limited period of time following termination

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Reimbursements and Fringe Benefits

Reimbursements and Fringe Benefits (cont'd)

- Reimbursements and fringe benefits not excluded from 409A can still comply with the “fixed payment” rule if:
 - Payable for an objectively prescribed period (which can be for the lifetime of the service provider); and
 - Amount of reimbursable expenses incurred or in-kind benefits available in one taxable year cannot affect the amount of reimbursable expenses or in-kind benefits available in a different taxable year (Lifetime maximum for medical benefits ok).

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Reimbursements and Fringe Benefits (cont'd)

Separation from Service

- For employees, means termination of employment
 - Determined under facts and circumstances
 - Presumed terminated if expected no further services provided or that level will not exceed 20% of average over prior 36 months
 - Presumed not terminated if exceed 50%
 - No presumption between 20% and 50%
 - Disregard leaves of absence
 - IRS won't "second guess" if facts change based on reasonable assumptions at time of deemed termination – e.g., come to back because the employer experiences an emergency
- Can use "same desk" rule for asset deals if specified no later than closing date – parties at arm's length can choose whether transferred employees experience a termination of employment

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Separation from Service

Specified Employees

- **Subject to six-month wait for payments following termination**
 - Can subsequently be accelerated only if employee dies before 6-month period ends
- **Specified employees generally include “top 50” officers of publicly-traded companies as well as certain 1% and 5% shareholders**

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Specified Employees

Specified Employees (cont'd)

- Regs provide a number of presumptions
 - Generally, determine “list” as of 12/31
 - That list then applies beginning the following 4/1 and continues through 3/31
- Regs provide flexibility
 - Can use different dates than 12/31 and 4/1
 - Choice of which definition of “compensation” to use for determining 50 highest-compensated officers
 - Unfortunately, no further clarification on who is an “officer”

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Specified Employees (cont'd)

Specified Employees (cont'd)

- Final regs allow use of alternative method as long as it is reasonably designed to capture all specified employees, it is objectively determinable, and it will not identify more than 200 employees
 - Must be in plan documents in advance

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Specified Employees (cont'd)

Specified Employees (cont'd)

- Final regulations provide rules for determining specified employees in various situations:
 - Public-private transactions (e.g., publicly-traded company acquired by a private company)
 - Private-public transactions (e.g., private company acquired by publicly-traded company)
 - Spinoffs (i.e., one public company becomes two)
 - Initial public offerings

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Specified Employees (cont'd)

Plan Aggregation Rules

- **Each service provider is deemed to have his/her own “plans”**
- **Plans of the same “type” are aggregated**
 - 409A violation with a type of plan adversely affects same type of plan covering the same service provider
- **Now nine types (four under the proposed regs):**
 - Elective account balance
 - Nonelective account balance
 - Nonaccount balance
 - Separation pay
 - Split-dollar life insurance
 - Reimbursement and in-kind benefit plans
 - Stock rights subject to 409A
 - Foreign plans
 - Other (“catch-all” category)
- **“Bifurcate” plans of different types if reflected in same documents**
- **This change is very helpful: may reduce consequences of 409A violations**

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Plan Aggregation Rules

What To Do in 2007

- **Transition Rules**
 - Good Faith through 12/31/07
 - Not required to follow final regs (although prudent to do so)
 - Payment election changes – this is the last “bite at the apple” before 409A’s severe restrictions kick in
- **Amend plans**
 - If do not reflect 409A by 12/31/07, violations deemed to occur 1/1/08

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What To Do in 2007

What Must a Plan Include?

- **Must be in writing**
- **Material terms must be included:**
 - Amount (or objectively determinable formula for determining) deferred compensation;
 - Time when deferral elections (if any) are irrevocable;
 - Payment events; and
 - 6-month delay if applicable
- **“Savings clause” insufficient**

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What Must a Plan Include?

What about 2005-2007 operations?

- Although documentary compliance not required until 12/31/07, 409A generally applies to compensation deferred on or after 1/1/05
- Do not need to retroactively amend plans to reflect operations during this period as long as there is evidence supporting actions (e.g., use of various payment transition rules)
 - Can be letters to employees, file memoranda, etc.

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What about 2005-2007 operations?

What Can We Expect From Future Guidance?

- Issues regarding inclusion of income
- Foreign trusts
- Partnerships

- Proposed legislation may also impact 409A

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What Can We Expect From Future Guidance?

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