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Proposed Section 409A Regulations Provide Relief and Planning Opportunities for 2005

By Mark Poerio, Ethan Lipsig, Steve Harris, and Eric Keller

The recent enactment of Internal Revenue Code (Code) Section 409A in the Fall of 2004 was the most significant U.S. employee benefit development since the passage of the Employee Retirement Income Security Act (ERISA) in 1974. This deceptively simple section revolutionizes nonqualified deferred compensation, principally by establishing deferral election deadlines, by regulating distribution practices, and by imposing harsh penalties for non-compliance.

Section 409A applies to a great deal more than just traditional nonqualified deferred compensation plans. Its broad ambit reaches individual agreements, equity-based compensation, and other benefits (including severance) that practitioners traditionally have not considered deferred compensation.

Every U.S. employer needs to act promptly to analyze the impact of Section 409A on its employees, directors, partners, and independent contractors, and on itself. Few will escape its reach. Most employers need to take proactive steps, some by the end of 2005, to preclude the imposition of significant

adverse tax consequences – income taxation in the later of the deferral or vesting year, a 20 percent excise tax, and interest penalties. Although these penalties would be imposed on the recipients of deferred compensation, their unanticipated imposition will create significant concerns for employers, such as demands for tax penalty gross-ups, and tax reporting and withholding issues.

Section 409A analysis is arcane because of its unexpectedly wide scope and complex rules. The only two official sets of guidance issued to date are IRS Notice 2005-1 (2005-2 I.R.B. 274, December 20, 2004) and Proposed Treasury Regulations §§ 1.409A-1 through 1.409A-6 (issued by the Internal Revenue Service and the Department of Treasury at the end of September 2005). IRS Notice 2005-1 has not yet been rescinded.

This client alert highlights key portions of the proposed Section 409A regulations.

KEY DATES WITHIN THE PROPOSED SECTION 409A REGULATIONS

Impact of Existing Guidance:

Notice 2005-1 generally remains in effect until the proposed Section 409A regulations are finalized.

Effective Date:

The proposed Section 409A regulations will not become final before January 1, 2007. Taxpayers, however, may rely on the proposed regulations to demonstrate good faith compliance with Section 409A.

Deadline #1:

December 31, 2005

- for terminating plans (without regard to the special plan termination rules discussed below) or refunding deferrals -- and making any plan amendments necessary to implement either action.
- for receiving cash compensation in exchange for canceling (or increasing the exercise price) of discounted stock options or stock appreciation rights in order to conform with Section 409A.

Deadline #2:

- for modifying existing distribution elections that either (i) apply to payments that would otherwise be made in 2006, or (ii) cause payments to be made in 2006.
- for making deferral elections as to most amounts that would be earned in 2006.
- for amending plans to authorize use of the extended March 15, 2005 deadline for 2005 deferral elections.

December 31, 2006

- for amending deferred compensation plans to either comply with Section 409A or satisfy an exemption.
- for modifying existing distribution elections that neither (i) apply to payments that would otherwise be made in 2006, nor (ii) cause payments to be made in 2006.
- for honoring distribution elections that are tied to payments from qualified plans.
- for substituting non-discounted stock options and stock appreciation rights for discounted stock options and SARS.
- for making deferral elections as to most compensation that would be paid for services performed in 2007.

WHAT'S NEW*Section 409A Exemption for Short-term Deferrals:*

The exemption for short-term deferrals is now permanent. Employers may delay payments beyond 2-1/2 months after the year in which vesting occurs in the event of unforeseeable administrative or employer solvency issues, provided payment occurs as soon as practicable.

Deferral Elections:

Short-term Deferrals. Deferral elections with respect to amounts that would be subject to the short-term deferral rule must occur more than 12 months before vesting and (i) payment must be deferred for at least five years past vesting (subject to earlier payment upon separation from employment, death, disability, or change in control), or (ii) the requirements for deferral elections associated with forfeitable compensation (discussed below) must be met.

Performance-based compensation. To qualify for the special rule permitting elections more than six months before the end of a performance period of at least 12 months, performance-based compensation must (i) be determined by objective or subjective performance criteria that are established in writing no later than 90 days after the commencement of the service period. Performance-based compensation includes compensation based solely on an increase in the value of service recipient stock.

Fiscal Year Compensation. If the service recipient has a fiscal year other than a calendar year, the service provider must make an initial election to defer "fiscal year compensation" at least by the close of the service recipient's fiscal year preceding the first fiscal year in which any services are performed for which the

compensation is payable. Fiscal year compensation means compensation relating to a period of service co-extensive with one or more consecutive fiscal years of the service recipient, of which no amount is paid or payable during the service period. This special rule does not apply to salary deferral elections.

Forfeitable Compensation. If the service provider will forfeit the right to receive compensation in a future tax year if the service provider does not continue to perform services for a period of at least 12 months, the service provider may make a deferred election within the 30-day period after being granted the right to the compensation, but no later than 12 months before the earliest date on which the forfeiture condition could lapse.

Commissions. Service providers must elect to defer commission payments in the calendar year before the service recipient receives the relevant customer payment. This rule provides for unique end-of-year deferral opportunities.

Distribution Events:

A plan may provide that payment will occur on the earlier of or the later of multiple permitted distribution events. Each event need not have the same payment terms.

A plan may provide that a payment schedule that complies with Section 409A will commence on the lapse of a substantial risk of forfeiture (such as an initial public offering, aka "IPO").

Separation from Service:

Participants who are on legitimate leaves of absence (e.g. military or sick) are treated as separating from employment on the later of six months and one day after the beginning of the leave or on the day that reemployment is no longer guaranteed by statute or contract.

A separation from service will occur if an employee services and compensation are reduced, as follows:

A separation from employment will occur if an employee transitions to independent contractor status unless he or she continues to provide services as an independent contractor at an annual rate equal to at least 50% of the services rendered during the prior three full calendar years (or the period of employment, if shorter) and receives compensation that is at least 50% of the average remuneration over that same period.

A separation from employment will occur if an employee continues to provide services as an employee at an annual rate equal to less than 20% of the prior services rendered and for compensation that is equal to at least 20% of the average remuneration over the three preceding full calendar years (or the period of employment, if shorter).

Change in Control:

"Change in Control" is no longer limited to corporations and now includes partnerships (but not yet other entities).

Second Elections:

For the purpose of applying the second election rules, a "payment" is each separately identified amount to which the service recipient is entitled, including amounts applied for the benefit of the service provider. Certain annuities are treated as a single payment, and a change in the form of payment from one such annuity to another before any annuity payment has been made is not considered a change in the time and form of payment, provided that the annuities are actuarially

Delays in Distribution:

equivalent. Installment payments are treated as a single payment, but a plan may provide that each installment is to be treated as a separate payment.

Changing from a form of payment that results in a more rapid schedule for payments (e.g., from installments to lump sum) does not violate Section 409A's prohibition on accelerating payments, but the change must comply with the subsequent election rules.

Even in the absence of an express plan or contractual provision, Section 409A will not be violated if a payment is delayed beyond its scheduled date until:

- (1) the first date on which it is administratively practicable to calculate and make the payment;
- (2) the end of the calendar year in which the payment is due, (or, if later, the 15th day of the third calendar month after payment is due);
- (3) the payment will not create a material risk of service recipient insolvency; or
- (4) resolution of a *bona fide* dispute.

In addition, a plan may provide for delayed, reduced, or even eliminated payments if:

- (1) there is a reasonable expectation of a lost Code section 162(m) deduction, or
- (2) material harm to the employer is reasonably expected to arise from violating applicable securities laws, loan covenants, or other contractual terms affecting the employer.

Note that a plan amendment adding one or more of these allowable delays cannot take effect for one year, although it is conceivable that action during the transition period may permit earlier effectiveness. Once added, such a provision cannot be deleted without causing an impermissible acceleration.

Six-Month Delay for Some Key Employees:

The Proposed 409 Regulations require that plan documents specify:

- (i) how a plan will determine who is a specified (key) employee, and therefore prohibited under Section 409A from receiving most payments within six months of terminating employment, and
- (ii) how suspended amounts will be paid (e.g., accumulated and paid at another specified date or by delaying all payments for at least six months).

Stock Options and SARs:

Exemptions from Section 409A are available even if the underlying common stock is that of a 50% or more affiliate (or a 20% or more affiliate if legitimate business criteria are present).

Exemption from Section 409A is possible for common stock American Depository Receipts (ADRs).

No exemption is available for preferred stock, or separate class of common stock except with respect to grants on or before December 31, 2004.

Valuation Issues:

Public Companies: four valuation methods are allowed:

- (1) last sale before or the first sale after the grant date;
- (2) closing price on the trading day before or on the grant date;
- (3) an average of the stock price over a fixed period occurring within 30 days of the grant; or
- (4) any other reasonable valuation method using actual transactions.

In the case of methods (3) and (4), the chosen method must be consistently applied for all Section 409A arrangements of the same type.

Private Companies: Any reasonable valuation method is allowed. Three methods are presumed to be reasonable and may only be overturned by IRS upon a showing of gross unreasonableness:

- (1) an independent appraisal made within 12 months that satisfies the criteria for ESOP appraisals;
- (2) a valuation formula that, if used as a non-lapse restriction under Code Section 83, would be considered fair market value under Code Section 83, provided that the formula must be used consistently for all transfers of such stock, including non-compensatory purposes and regulatory filings;
- (3) a valuation for certain start-up companies must be based on a written report that takes into account certain specified factors and may not be used if change in control or IPO occurs within 12 months.

Modifications:

Certain material modifications, which result in a deemed new grant for Section 409A purposes, include changes that reduce the exercise price for an option or SAR, add a tax deferral feature, or extend or renew the option.

Disregarded for this Section 409A purpose are modifications that:

- (i) adjust the number of shares and exercise price for stock splits, stock dividends, or certain business transactions in accordance with Code Section 424(a);
- (ii) permit cashless exercise;
- (iii) extend the exercise period until the later of December 31st of year or 15th day of third month after expiration otherwise would have occurred;
- (iv) extend the exercise period until 30 days after lapse of securities law trading restrictions; or
- (v) permit limited transfers to family members or family trusts.

Note: the Proposed Regulations do not eliminate the stock gain deferral alternative discussed in our client alert dated September 15, 2005. For a copy of that alert or with questions, contact markpoerio@paulhastings.com.

Limited Rescission Right:

Permits limited right to fix inadvertent modifications by rescinding the modification before the earlier of the date any additional right under the modification is exercised or the end of the calendar year of the modification.

Restricted Property, RSUs and Other Forfeitable Rights:

Deferral elections are allowed within 30 days after award date if vesting period is at least 12 months (at least a 13-month vesting period is necessary to permit full use of this rule).

Stock Appreciation Rights:

Generally exempt from Section 409A if granted at fair market value, even if settled in cash and even if the underlying common stock is not readily tradable on an established securities market. The stock option exemption requirements generally are equally applicable.

Separation Pay:

Exemptions from Section 409A are available to the extent:

- (1) employer reserves the discretion to prospectively eliminate the arrangement at any time.
- (2) a plan (including a voluntary window plan) that is collectively bargained (only applies to the portion of the plan attributable to collectively-bargained employees);

- (3) total severance pay and benefits are less than \$5,000 for the employee; or
- (4) the plan (including a voluntary window plan) provides total payments (other than certain expense reimbursements) that do not exceed two times the lesser of the employee's annual compensation or the annual Code section 401(a)(17) limit (currently \$210,000) and all payments are made by the end of the second calendar year after the year of employment termination.

Deferral elections are allowed under a voluntary window plan if made on or before an employee's election to participate in a window program becomes irrevocable. Adoption of serial voluntary window plans may make this exception unavailable.

Deferral elections are allowed under a bona fide negotiated separation arrangement if made on or before the employee obtains a legally binding right to receive the separation pay.

A "good reason" resignation right is not necessarily treated "as a right subject to a substantial risk of forfeiture," principally meaning that a severance plan with such a provision likely will be subject to Section 409A and must comply with it, e.g., by delaying separation pay to a specified employee for the six-month period following termination of employment, or later.

For purposes of Section 409A, all members of an employer's controlled group are considered to be "service recipients."

Reimbursements:

Section 409A generally applies to reimbursement arrangements that extend beyond the year in which the right to reimbursement arises.

Certain reimbursements related to separation pay may be exempt from Section 409A to the extent incurred and reimbursed before the end of the second calendar year after the year in which employment terminates.

Split-Dollar Life Insurance:

Generally exempt from Section 409A if structured as a loan arrangement. Death benefit only policies are also excluded. Subject to Section 409A if the company owns the policy (i.e., endorsement method).

Tax-qualified Plans:

Special rules relax the Section 409A rules applicable to deferral elections linked to qualified plans and other linkages.

Plan Aggregation:

Deviations from plan terms may trigger Section 409A penalties for more than just the participant in question if the violation is not isolated or involves a class of participants.

Plans are aggregated on a participant by participant basis by type for penalty and other purposes, e.g., plan termination, special initial eligibility rule, etc.

Severance pay is a separate type of Section 409A arrangement from account balance plans (defined contribution), nonaccount balance plans (defined benefit), and equity compensation plans.

Plan Terminations:

Plans may terminate under three circumstances without causing an impermissible acceleration:

- (1) within 12 months following a change in control;
- (2) upon a corporate dissolution; or
- (3) through payment of all benefits between 12 and 24 months after plan termination, if (i) only regularly-scheduled payments are made within the 12 months

Section 409A Penalties:

following plan termination; (ii) all plans of the same type are terminated; and (iii) no plan of that type (e.g., account balance) is adopted for at least five years.

Not addressed in the Proposed Regulations.

Generally the terms of the plan, arrangement, or agreement establishing rights will determine the extent to which Section 409A violations occur.

International and Ex Pat Issues:

This will be addressed separately during our November 10th teleconference, which will be jointly sponsored by our International Employment Group.

FOLLOW-UP ALERTS AND TELECONFERENCES

We will issue six special client alerts and hold six more teleconferences on specific Section 409A issues. The schedule for the teleconferences (all to be held from 1:00 P.M. to 2:30 P.M. Eastern Time) follows:

- October 13 Year-End Deadlines for 2005
- October 20 Section 409A Coverage Issues and Exemptions, including the Short-term Deferral Rule
- October 27 Deferral and Distribution Elections
- November 3 Equity Compensation
- November 10 International Issues
- November 17 Severance Pay

To register for any teleconference, or if you have any questions, please contact cathybynum@paulhastings.com.

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