



A Law Firm in the People Business

December 31, 2007 Amendment Deadline

The Final Regulations provide that all deferred compensation arrangements that are subject to 409A must be amended by December 31, 2007, to reflect the terms of the Final Regulations. If a document fails to properly include these rules, the 20% additional tax and other 409A penalties will be triggered even if the operation of the arrangement complies with 409A.

The Final Regulations specifically provide that all arrangements subject to 409A must specify each of the following: (i) the amount payable, (ii) the timing and form of payment, (iii) any participant election rules, and (iv) if applicable, the 6-month delay for specified employees of public companies. Though plans are not required to detail every aspect of the Final Regulations (*e.g.*, benefit payments can be accelerated under limited circumstances even if not provided in the plan document), they are required to contain any exceptions or modifications made to the “default” rules under the Final Regulations. For example, if an employer wants to identify its employees subject to the 6-month delay as of a date other than December 31, it must specify this in the plan documents.

Some Significant Changes Made by the Final 409A Regulations

Regulations under Section 409A of the Internal Revenue Code (“409A”) were finalized earlier this month (the “Final Regulations”). Although the Final Regulations retain the same basic structure as the regulations that were proposed in 2005 (the “Proposed Regulations”), they make numerous tweaks, enhancements and clarifications to the rules. Following is a brief description of some of the most significant of these changes:

- **Extension of Stock Options.** Like the Proposed Regulations, the Final Regulations provide that certain stock options that are granted at fair market value are exempt from 409A. Subject to a limited exception, the Proposed Regulations provided that any extension of a stock option would be treated as the grant of a new option, and, if the fair market value of the stock on the date of extension exceeded its exercise price, 409A would be violated from the original grant date of the option.

The Final Regulations greatly expand the circumstances under which an option can be extended without violating 409A. Under the Final Regulations, an option may be extended until the earlier of (i) the original maximum term of the option or (ii) 10 years from the date of the original grant. In addition, an “underwater” option (*i.e.*, an option whose exercise price exceeds the current fair market value of the stock) may be extended for any period.

- **Exempt Separation Pay Arrangements.** The Proposed Regulations exempted certain separation pay arrangements from 409A, and the Final Regulations expand these exemptions. The majority of the separation pay exemptions under the Proposed Regulations were limited to amounts that were only payable upon involuntary termination or participation in a window program. The Final Regulations expand the concept of involuntary termination in this context to include voluntary terminations that are on account of certain “good reason” conditions (such as a material reduction in the employee’s base compensation).

Also, under the Final Regulations, each of the possible separation pay exemptions can be “stacked” to determine whether all or a portion of a separation pay arrangement is subject to 409A. For example, certain types of separation payments are exempt from 409A if they do not exceed a specified dollar amount and do not extend beyond the end of the second year following the year of separation. Some payments under a separation pay arrangement may be structured to satisfy this exemption even if other payments under that same arrangement do not, and the payments that do not satisfy this exemption may qualify for another one.

- **Separations from Service.** The Final Regulations modify some of the rules for determining whether an employee has had a separation from service. Under the Final Regulations, an employee whose services drop to 20% or less of the services he or she performed during the preceding 3 years will be presumed to have separated from service. An employee whose services remain at 50% or more of the services he or she was performing during the preceding 3 years will be presumed to have not separated from service. Unlike the Proposed Regulations, these rules no longer consider whether an employee's compensation has also dropped.

The Final Regulations also clarify when employees who are affected by certain corporate transactions will have a separation from service. If an employer's stock is acquired, its employees will not be treated as separating from service. But, if an employer's assets are acquired, the buyer and seller may agree whether or not to treat the affected employees as separating from service.

- **Employees Subject to the 6-Month Delay.** Under 409A, distributions to certain "specified employees" of public companies (generally, the top-paid 50 officers of the company and its subsidiaries) on account of separation from service must be delayed for 6 months. The Final Regulations clarify and expand the rules for identifying employees subject to this limitation. For example, the Final Regulations provide that, unless all of an employer's plans specify otherwise, foreign-source income earned by nonresident aliens is taken into account for this purpose. This means that companies with significant foreign operations will need to either track compensation paid to officers outside of the U.S. or choose an alternative definition of "compensation" for this purpose.

Subject to certain limitations, the Final Regulations also provide that employers may use alternative methods for identifying employees subject to the 6-month delay. For example, an employer may be able to apply the 6-month delay to all of its officers and avoid having to identify the top-paid group each year.

- **Alternative Forms of Distribution Following Certain Separations from Service.** The Proposed Regulations provided that distributions on account of separation from service could be made in a different form (*e.g.*, a lump sum or installments) if the separation from service occurred before or after a specified date (such as the date the employee attains a certain age). The Final Regulations expand this rule and also permit alternative forms of distribution for separations from service occurring within 2 years after a change in control and before or after the employee has completed a certain period of service.
- **Deferring Commissions.** Generally, 409A provides that deferral elections must be made before the tax year during which the employee performs services to which the compensation relates. Because it is not always clear when an employee performs the services to which commission payments relate, the Proposed Regulations provided that certain commissions may be treated as earned during the year in which the employer receives payment from the customer. The Final Regulations expand this rule to provide that an employer may alternatively treat the year in which the sale occurs as the year in which the applicable services were performed.
- **Early Payment on Death, Disability or Change in Control.** The Proposed Regulations provided a special deferral timing rule for certain ad hoc grants. Employees could make deferral elections up to 30 days after the date on which these grants were made as long as the grant did not vest for at least 12 months after the deferral election was made. The Final Regulations allow this special deferral timing rule to be used even though the grants may vest earlier on account of death, disability or change in control.

These are just a quick overview of a few of the many changes made by the Final Regulations. Please plan to join us on Wednesday May 16, 2007, from 7:30 a.m. to 9:30 a.m. for a *Benefits with Breakfast* seminar to address these and many other changes in the Final Regulations in greater detail. We will provide more information about this seminar shortly.

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