

GROOM LAW GROUP, CHARTERED

2007 Employee Benefits Seminar

Executive Compensation Update

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Topics: **Hot 409A Issues**
 Plan Design Trends
 Pending 409A/162m Legislation

Materials: **Presentation**
 IRS Provides Limited Relief From Section 409A Deadline

Executive Compensation Update



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Overview

- 409A Transition Relief/Additional Guidance
- 409A Design Issues
- Pending 409A and 162(m) Legislation

409A Transition Relief/ Additional Guidance

- ❑ Transition Relief / IRS Notice 2007-86
- ❑ Good Reason
- ❑ Cash Outs
- ❑ Voluntary Compliance Program
- ❑ Certain Trust Relief

Transition Relief

IRS Notice 2007-86

- Extension of “Good Faith” Compliance Period to December 31, 2008
 - Applies if the plan is operated in good faith compliance with the provisions of 409A and the IRS guidance
 - Not required to follow the final or proposed regulations
 - Compliance with final regulations is deemed good faith
 - May not rely on proposed regulations after 2007
 - Plan is amended by 12/31/08

Transition Relief

IRS Notice 2007-86

- Transition Relief Applies to:
 - Drafting plan documents
 - Changing distribution elections
 - "Piggyback elections" of distribution option with qualified plan
 - Stock options and SARs, other than for Section 16 officers, that are subject to 409A can be substituted with stock options and SARs that are exempt from 409A

2007/2008 Design Decisions

- De-link SERPs
- Determine time and form of payment under all nonqualified plans
- Designs exempt from 409A
 - Severance
 - Change in Control Agreements

Good Reason

- Exempt Design under 409A
 - Short-term deferral exemption
 - Two times / two year exemption
- Modification of Good Reason Payment Event Before 2009
- IRS Concern Regarding Substantial Risk of Forfeiture
- “Double Trigger” vs. “Single Trigger” Arrangements

Cash Outs

- ❑ Permitted Acceleration if Account Value is Below 402(g) Limit (\$15,500 for 2007)
- ❑ Minimum Cash Out Provisions for Other Predetermined Amounts (e.g., \$50,000)
- ❑ IRS Concern Regarding Abusive Provisions Providing Late Time or Form Elections

Voluntary Compliance Program

- ❑ Future IRS Guidance for Limited Voluntary Compliance Program
- ❑ Unintentional Operational Failures Corrected During Same Tax Year of Failure
- ❑ Other Methods for Correction of Certain Unintentional Operational Failures

Certain Trust Relief

- ❑ Prohibited Funding Arrangements Under 409A(b)
 - Offshore trusts
 - Financial health triggers
 - Funding during “Restricted Period”
- ❑ Extension of “Good Faith” Compliance Period Under 409A(b)
- ❑ No Extension of Prior Transition Relief for Grace Period Assets

409A Design Issues

- ❑ Offsetting NQDB Plans
- ❑ Pension Make-Up for Elective Deferrals
- ❑ Alternative Payment Schedule Rules
- ❑ Post-Termination Benefits

Offsetting NQDB Plans

- ❑ Formula for one NQDB plan contains offset based on benefits in second NQDB plan
- ❑ IRS concern where benefit “moves” from one plan to the other and distribution scheme changes (e.g., from annuity to lump sum)
- ❑ Fix by having same time and form of payment under both plans

Pension Make-Up for Elective Deferrals

- ❑ NQ plan deferrals reduce “compensation” under qualified DB plan
- ❑ NQDB plan provides benefits that would have been earned under qualified DB plan but for deferral (“pension make-up”)
- ❑ IRS personnel may have concern with this design in some cases
- ❑ Seems to fit within regulation rules

Alternative Payment Schedule Rules

- ❑ Regulations allow for alternative payment schedules based on whether triggering event occurs before or after one specified date
- ❑ For example, lump sum if separation from service (SFS) occurs before age 55 or annuity if SFS occurs after 55
- ❑ Additional flexibility for SFS under this rule

Alternative Payment Schedule Rules (continued)

- ❑ Common design is to provide for different time/form based on SFS before/after “retirement age”
- ❑ “Retirement age” can be based on age or age and service (e.g., 55 and 10)
- ❑ Service period must be objectively determinable or based on qualified plan definition (e.g., years of vesting service)

Post-Termination Benefits

- ❑ Taxable medical benefits
- ❑ Post-termination reimbursements
- ❑ Tax gross-ups
- ❑ Exemptions
- ❑ Compliance and application of six-month delay for key employees

Pending 409A and 162(m) Legislation

- ❑ 409A Cap on Annual Deferrals
- ❑ Expansion of 162(m)
- ❑ Proposals Targeted at Private Equity and Hedge Funds
- ❑ Prospects
- ❑ Possible Impact on NQDC Design

409A Cap on Annual Deferrals

- Included in Senate-Passed Legislation Earlier This Year
- Proposed 409A Cap on Annual Deferrals
 - Lesser of \$1 million or 5-year average annual taxable compensation
 - Aggregation of different types of nonqualified plans
 - Earnings included
 - Calculation of annual deferral amounts
 - Application of 409A penalties to violations
- Effective Beginning in 2007

409A Cap on Annual Deferrals (continued)

- Likely Changes to Proposal
 - \$1 million annual cap (possibly indexed)
 - Exclusion of “earnings”
 - Limited exclusion for DB “mirror plans”
 - Correction program (possibly for 409A generally)
 - Broader short-term deferral exemption
 - Rules on measuring deferrals
- Changes to Effective Date

Expansion of 162(m)

- Also included in Senate–Passed Legislation
- Expanded Definition of “Covered Employee”
 - CEO at any time during year
 - Four officers with highest compensation
 - No requirement of employment on last day of year

Expansion of 162(m) (continued)

- ❑ De-link Highest-Paid Officer Determination from SEC Proxy Rules
- ❑ Permanent Covered Employee Status
- ❑ Effective Beginning in 2007
- ❑ No Grandfather for Binding Contracts

Expansion of 162(m) (continued)

- Likely Changes to Proposal
 - Definition of highest-paid officers separate from SEC rules but similar concepts
 - Limited binding contract exception based on timing of accruals

Proposals Targeted at Private Equity and Hedge Funds

- Publicly-Traded Partnerships
- Carried Interest
- Offshore Deferred Compensation (New 457A)
 - Bill introduced by Rep. Emanuel / Sen. Kerry
 - Aimed at hedge fund managers in offshore corporations
 - Tax compensation deferred under plan of “nonqualified foreign corporation” at vesting
 - Definition of nonqualified foreign corporation

Prospects

- Pay-Go
- Need for Revenue Offsets
- Senate Education Bill
- AMT / Tax Extenders Legislation
 - Senate
 - 1-year AMT patch and 2-year tax extenders provision
 - Disagreement on Finance Committee over pay-go/offsets
 - Possible use of 409A cap and 162(m) as raisers

Prospects (continued)

- House

- Broad AMT / tax reform bill – timing slipping
- 1-year AMT patch and tax extenders provision
- Likely adherence to pay-go
- Uncertainty as to revenue offsets

Possible Impact on NQDC Design

- Increased Complexity
- Increased Importance of Exemptions
 - Short-term deferral
 - Severance Two Times/Two Year Exemption
- Impact on 162(m) Designs

IRS Provides Limited Relief from Section 409A Deadline

On September 10, 2007, the IRS issued Notice 2007-78 (the "Notice") providing the following transition relief and additional guidance under Code section 409A:

- Extension to December 31, 2008, of the deadline by which plans subject to section 409A must be in full documentary compliance.
- Confirmation that the "good faith" compliance period and other transition relief generally ends on December 31, 2007.
- Guidance addressing issues raised by "good reason" payment triggers and lump sum cash-out features.
- Announcement that the IRS anticipates establishing a limited voluntary compliance program to correct certain unintentional operational violations.

The Notice provides welcome news with regard to the cash-out issue, the addition of section 409A compliant "good reason" payment triggers in change in control agreements and the promise of a voluntary correction program. However, we believe most employers will not find the limited transition relief provided by the Notice to be of much help. ***By the end of 2007, employers will still need to make many major design decisions for arrangements potentially subject to section 409A, be in strict operational compliance with section 409A, and document the major design decisions made.***

I. Background

On April 10, 2007, the IRS issued final regulations under section 409A (the "Final Regulations").¹ The Final Regulations address the scope of section 409A and provide the rules for deferral elections and distributions under plans subject to section 409A. Significantly, the Final Regulations did not extend the "transition period" for section 409A compliance (which had been extended most recently by Notice 2006-79) and required full documentary and operational compliance by December 31, 2007.

Following issuance of the Final Regulations, the business and legal communities requested that the IRS extend the transition period so that companies could have more time to make design decisions, have those decisions approved at the appropriate level and then commit the new designs to writing. The Notice is the IRS' response to these requests.

¹ 72 Fed. Reg. 19233 (Apr. 17, 2007). For summaries of previous IRS guidance under section 409A, including the Final Regulations, please see <http://www.groom.com/library/ExecutiveCompensation.html>.

II. What Employers Still Must Do Before 2008

Despite the relief provided in the Notice, employers will still need to take the following actions by the end of 2007.

Make Major Design Decisions

Many employers still need to decide how arrangements will be structured after 2007 to either fit within an exemption from section 409A or to comply with section 409A. For the past few years, the IRS has made transition relief available to facilitate this restructuring. The Notice makes clear that this transition relief period will end on December 31, 2007. Therefore, companies have only until the end of 2007 to take the following actions with respect to amounts potentially subject to section 409A:

- De-link distributions under nonqualified plans that are controlled by distributions under qualified plans (so called "piggyback plans").
- Change the time and/or form of distributions without complying with the subsequent election (the "12-month/5-year rule") and anti-acceleration rules.
- Replace stock options and stock appreciation rights (SARs) that are subject to section 409A (e.g., discounted options) with exempt options or SARs or revise them to provide section 409A compliant fixed payment terms.

Be In Strict Operational Compliance

Notice 2007-78 also makes clear that the "good faith" compliance period, which has also been available the past few years, will end on December 31, 2007. Therefore, strict operational compliance with section 409A and the Final Regulations is required as of January 1, 2008. For arrangements that remain subject to 409A on this date, employers need to be ready to operate the arrangements in accordance with the new 409A-compliant structures created.

Document Basic Distribution Rules

While providing limited relief from the documentary requirements, the Notice still requires that companies document the basic 409A-compliant distribution rules for amounts subject to section 409A before the end of 2007. The documentary requirements and the relief provided by the Notice in this area are described below.

III. Documentary Requirements

The Final Regulations provided the following guidance on the requirement that the material terms of an arrangements subject to section 409A be in writing, effective January 1, 2008:

- The written terms of an arrangement may be in one or more documents.
- At the time an amount is deferred, the plan documents must specify the amount ultimately to be paid (or an objectively determinable, non-discretionary formula to calculate it) and the time and the form of payment.
- The plan documents must set forth the conditions under which deferral elections and subsequent deferral elections may be made.
- Plan documents must contain the six-month delay rule on payment to key employees of public companies by the time an employee becomes subject to the rule.

Retroactive Amendment Period Granted

The Notice provides a "remedial amendment period" for arrangements covered by section 409A. Specifically, the Notice provides that, with the major exception described below, a plan will not violate section 409A merely because it fails to meet the documentary requirements if it is operated in accordance with section 409A and is amended by the end of 2008 to comply retroactively to January 1, 2008. Thus, the Notice allows companies to disregard non-section 409A compliant terms that remain in a plan document (e.g., a "haircut" provision) during 2008 as long as such terms are not used in operation.

A plan is treated as having been amended to comply retroactively to January 1, 2008 if the amended plan contains all of the written provisions required by the Final Regulations and accurately reflects the operation of the plan from January 1, 2008 through the date of amendment, including (i) the terms and conditions under which any initial or subsequent deferral elections were permitted, and (ii) how the operation of the plan met the 409A requirements from January 1, 2008 through the date of the amendment.

Time and Form of Payment Must be Documented Before 2008

The Notice describes the guidelines under which a plan may be treated as meeting the Final Regulations' requirement to timely document a time and form of payment of an amount deferred under the plan. For amounts that remain unpaid as of January 1, 2008, a plan must designate in writing before January 1, 2008, a 409A-compliant time and form of payment (e.g., lump sum at separation from service). As to amounts to be deferred in 2008, a plan must designate in writing a 409A-compliant time and form of payment by the deadline for electing to defer such amounts under the Final Regulations (e.g., for deferred salary, generally the end of the year before the year in which the salary is earned).

A plan may provide before 2008 that a deferred amount is to be paid upon the earliest or the latest of a number of permissible payment events (e.g., separation from service, death, disability). However, if a payment event is not specified in writing as a potential payment event before 2008, the addition of that payment event (e.g., change in control) is subject to the anti-acceleration and subsequent deferral rules under the Final Regulations. Similarly, if a payment event is specified in writing before 2008 as a potential payment event, the removal of the

payment event after 2007 is also subject to the anti-acceleration and subsequent deferral election rules under the Final Regulations.

Retroactive Adoption of Permissible Payment Event Definitions

While the basic distribution rules for amounts subject to section 409A must be documented by the end of 2007, the Notice provides that definitions for the permissible payment events that are used under a plan in 2008 need not be documented until the end of 2008. For example, any permissible alternatives utilized in determining whether a separation from service or change in control occurred in 2008 need not be documented until the end of 2008.

Time For Making Payments After Event

The Notice also permits employers to fine tune their distribution rules by providing that the following types of changes made in 2008 will not be treated as a change in the time or form of payment (and therefore not subject to the "12 month/5 year rule"):

- The addition or deletion of a post-event payment provision that meets the requirements of the Final Regulations, and does not affect the taxable year in which the payment will be made (e.g., if a plan provides for a lump sum payment upon death, providing that payment will be made before the end of the year in which death occurs).
- The addition, deletion or modification of a provision that payment will be made during a designated period following a distribution event (e.g., if a plan provides for a lump sum payment upon separation from service, providing that payment will be made within 90 days following separation from service).

Six-Month Delay on Payments to Key Employees

Provided that the six-month delay rule applicable to key employees of public companies is applied properly, a plan will not be treated as failing the documentation requirements as long as: (i) the plan is amended before the end of 2008, retroactive to January 1, 2008, to contain this requirement, and (ii) the amended plan accurately reflects the operation of the plan through the date of the amendment. An employer still must be able to demonstrate that during 2008 the six-month delay was applied to affected payments and that the rules used for identifying key employees was applied consistently to all plans and all employees.

IV. "Good Reason" Provisions

Two exemptions from section 409A can apply to severance payments if they are payable only upon involuntary termination (the short-term deferral and the "two times pay" exemptions). The Final Regulations allow terminations on account of "good reason" to be deemed involuntary for purposes of these rules if certain requirements are met. Thus, many employers have considered modifying employment and change in control arrangements that contain good reason payment triggers to meet these requirements. However, IRS personnel have expressed concern as to whether an arrangement may be amended even during the transition period to do so.

The Notice states that such a modification will work if: (i) amounts payable under an arrangement are currently subject to a substantial risk of forfeiture (e.g., the severance is only payable if a change in control occurs first); and (ii) the modification is made by the end of 2007. Consistent with transition relief rules for 2007, the Notice states that such modifications made in 2007 may not affect amounts that are otherwise payable in 2007.

This is welcome news for employers who still are interested in such modifications, particularly with respect to "double trigger" arrangements that provide severance benefits to executives who terminate for good reason after a change in control. The Notice does not provide any helpful guidance on modifying arrangements that provide for severance upon a good reason termination without an additional condition.

V. Employment Agreements – Substitution Rule

Employers have also worried about the Final Regulation rule that generally provides that amounts payable in "substitution" for amounts subject to section 409A will be subject to section 409A. The Notice provides generally that if an employment agreement provides for payments upon an involuntary termination but the right to those payments is forfeited at the expiration of the agreement, then a similar provision in a new or renewed agreement will not be treated as a substitute for the forfeited right.

VI. Predetermined Cash-outs

Many plans contain a provision for a lump sum payment at separation from service (or some other permissible payment event) if the value of a participant's benefit at that date is below a predetermined amount (e.g., \$50,000). The proposed regulations under section 409A made fairly clear that such a provision was compliant. However, the Final Regulations were less clear on this point, and IRS personnel have since questioned whether such a cash-out provision was permissible under 409A.

The Notice states that the IRS has some concerns with this type of provision, but until further notice a company may generally treat such a provision as 409A compliant if (i) the 409A distribution rules are otherwise met, i.e., the cash-out amount is fixed when the distribution rules are established, and (ii) the taxpayer can demonstrate that the provision operated in an objective, nondiscretionary manner and did not effectively provide the employee or employer the ability to make a late election as to the time and form of payment.

Note that the Final Regulations clearly permit (i) a feature whereby a benefit payable in installments or an annuity will be cashed out in a lump sum if the value of the remaining payments drops below a specified amount at any time, and (ii) an employer to accelerate and pay out in a lump sum a participant's benefit if the value is below the Code section 402(g) limit (\$15,500 for 2007).

VII. Anticipated Voluntary Compliance Program

The Notice states that the IRS anticipates issuing guidance in the near future establishing a limited voluntary compliance program under 409A. The program will apply to certain unintentional operational failures to comply that are corrected in the same taxable year in which the operational failure occurred, and will also provide other methods by which certain unintentional operational failures may result in only limited amounts becoming subject to adverse treatment under section 409A. This is also welcome relief for employers and executives who are beginning to realize how difficult strict compliance with section 409A will be. Unfortunately, the Notice is silent on the possibility of the IRS issuing advance rulings on section 409A plans.

VIII. Restrictions on Certain Trusts and Other Arrangements

Section 409A(b) generally prohibits the following "funding" arrangements for nonqualified deferred compensation plans:

- offshore trusts,
- restricting assets to protect a participants' deferred compensation when the employer's financial health is threatened, and
- transferring assets to a trust (including a typical rabbi trust) to protect a participants' deferred compensation when the employer is in a "restricted period" with respect to a single-employer defined benefit plan.

If these prohibitions are violated, relevant assets are includible in the employee's income and the employee will be liable for the additional section 409A taxes on the resulting income inclusion.

The Notice extends the "good faith" compliance period under section 409A(b) that was provided under prior guidance (Notice 2006-33). That is, until further guidance is issued, companies may continue to rely on a reasonable, good faith interpretation of section 409A(b) to determine whether the use of a trust or other funding arrangement causes a problem. However, the Notice emphasizes that prior transition relief under these rules for "grace period assets" (i.e., assets that were set aside, transferred or restricted under a plan on or before March 21, 2006) will not be extended beyond the end of 2007. Thus, such assets will be subject to inclusion and additional section 409A penalties as of January 1, 2008 if the plan under which such assets were set aside, transferred or restricted is not amended to comply with a reasonable, good faith interpretation of section 409A(b) before the end of 2007.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about the Notice or its impact on your executive compensation arrangements.

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