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Treasury, IRS and SEC Officials Comment on Current Executive Compensation Issues

The American Law Institute-American Bar Association (ALI-ABA) recently held its two-day annual conference, Executive Compensation: Strategy, Design, and Implementation. Representatives from the Treasury, Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC) presented the latest government views on upcoming guidance under Code section 409A, stock option grant timing, and the new SEC disclosure rules for executive compensation. We share some of their observations here. In addition, we summarize the IRS's recently issued interim guidance providing relief from the section 409A rules for payments made to comply with federal government ethics rules.

A. Section 409A Guidance Topics

Timing of Final Regulations/Extension of Transition Relief. Regulations under 409A are still expected in the "late summer or early fall." Treasury and IRS representatives suggested that perhaps not all of the currently proposed 409A regulations would be finalized at that time, but a portion may be re-proposed. Treasury and IRS representatives also indicated that an extension of all or some of the transition relief that was granted under the Proposed Regulations may be warranted, but it is not clear how long such an extension might last.

"Bifurcation" of Severance Arrangements. The IRS received numerous comments requesting that severance amounts exempt from 409A not be aggregated with amounts subject to 409A where the amounts are payable under the same arrangement. This issue may arise in the context of involuntary severance pay arrangements. A severance arrangement that provides for payments upon an involuntary termination of employment may be exempt from 409A if the entire amount payable under the arrangement does not exceed two-times the employee's annual compensation or, if less, two-times the maximum amount of compensation that can be taken into account under a qualified plan under Code section 401(a)(17), indexed (e.g., two-times this amount for 2006 terminations is $420,000). The IRS is considering whether to allow "bifurcation" of involuntary separation pay amounts that exceed the two-times pay limitation. Under that approach, the amount falling under the cap (e.g., $420,000 in 2006) would be exempt from 409A, while the amount over the limitation would remain subject to 409A (e.g., six-month delay for "key employees"). This would allow more flexibility in the design of purely involuntary separation pay arrangements.

"Good Reason" Payment Triggers. Even where a severance arrangement does not fit within the safe-harbor exception for involuntary separation pay arrangements described above, it may still fit within the "short-term deferral" exception generally covering amounts payable within 2 ½ months of the year of vesting. If a plan provides for severance upon a voluntary termination (e.g., for "good reason"), the preamble implies that the short-term deferral exception

will not apply though the IRS requested comments on this issue. Treasury and IRS representatives said that the IRS has received two types of comments and that both are being considered: (1) comments requesting a safe-harbor definition of "good reason" that would allow an arrangement to use this exception, and (2) comments requesting a "facts and circumstances" test to determine whether a particular "good reason" definition works.

Stock Option and SAR Issues. The Proposed Regulations set forth rules governing the types of modifications, extensions, or renewals of stock options and SARs that could subject an otherwise exempt award to 409A. Treasury and IRS representatives indicated that consideration is being given to relief for certain stock option exercise extensions that are merely "interim" measures and which arise in certain specific circumstances. For example, relief may be provided where an employee with stock options is terminated in connection with an asset sale or even in some instances unrelated to any transaction. The employee's termination may trigger a shortening of the option exercise period (e.g., 90 days following termination) even though the buyer intends to hire the employee and would like to continue to motivate the employee with the same stock option following the employee's hire. To accomplish that, the buyer may need to extend the employee's option exercise period. Under the Proposed Regulations, it is unclear whether this type of interim extension of the stock option exercise period would be considered a modification of the stock option that would subject the grant to 409A. We expect clarification of this issue, but the scope is unclear at this point.

The Proposed Regulations exempt options and SARs covering certain types and classes of stock – called "service recipient stock." "Service recipient stock" under the Proposed Regulations generally is limited to one class of stock per controlled group. IRS is considering comments that request a broader definition of service recipient stock, which might include, for example, stock of more than just the public company in a controlled group (e.g., stock of a wholly-owned company in a particular line of business). Moreover, additional guidance is anticipated that will clarify how the service recipient stock rules will work in other types of business arrangements, like joint ventures.

Other Future Guidance. Future guidance can be expected as to the following issues:

- measurement of amounts deferred under arrangements subject to 409A,
- tax reporting of deferrals and income inclusions (practitioners can expect guidance with respect to 2006 reporting obligations similar to that provided for the 2005 tax year), and
- offshore funding and financial health triggers.

Interestingly, the Treasury and IRS representatives also indicated that consideration was being given to guidance on the issue of correcting 409A violations. It is not clear when any of the additional guidance listed above might be expected.

B. Timing of Stock Option Grants

Another "hot topic" that was discussed periodically throughout the conference was the timing of stock option grants, known in more pejorative terms as "stock option backdating". Options that are not granted at fair market value create potentially significant tax issues for companies and executives, including under Code sections 409A, 162(m), and 422. This practice also may create the need for financial restatements and other disclosures. Speakers suggested that companies review their current stock option grant practices, prepare for increased audit attention (e.g., both internally under Sarbanes-Oxley and externally), expect increased scrutiny from directors and officers insurance carriers, and in some cases, prepare for increased attention from the media and shareholders.

C. New SEC Disclosure Rules

SEC representatives indicated that it was still the SEC's intention and desire to finalize the recently proposed SEC disclosure rules for executive compensation in time for the 2007 proxy season. Some companies are already filing proxy materials in accordance with the standards set forth in the proposed rules, although that is not necessary. Not surprisingly, indications are that the final rules may include supplemental requirements regarding disclosure of a company's option grant practices.

D. New 409A Guidance

On June 30, 2006, the IRS released Notice 2006-64, which provides some expanded relief from the 409A anti-acceleration rules for certain payments made to comply with federal ethics rules. Code section 409A(a)(3) provides generally that the acceleration of deferred compensation payments violates 409A, except as provided in regulations. Both Notice 2005-1 and the Proposed Regulations provide an exemption for the acceleration of the time and schedule of payment of nonqualified deferred compensation in order to comply with a certificate of divestiture, as issued by the federal Office of Government Ethics. Commentators (including the Groom Law Group) pointed out to the IRS and Treasury that the exception was too narrow and that many early payments of deferred compensation that are necessary to meet government ethics requirements would not fit within this exception.

Notice 2006-64 expands the exception from the anti-acceleration rule for early payments of nonqualified deferred compensation to include payments that are necessary to satisfy the requirements of a written determination by the Office of Government Ethics. The written determination must (1) provide that the divestiture of the financial interest is either (a) reasonably necessary to comply with any Federal conflict of interest rule or (b) requested by a congressional committee as a condition of confirmation; and (2) specify the financial interest to be divested. The Notice points out that the amounts received must be included in income. Undoubtedly, this guidance will be reflected in the regulations when they are issued later this year.

One of the first taxpayers to rely on this expanded relief could be the new Secretary of the Treasury, Henry Paulson, who as the former head of Goldman Sachs may have had deferred compensation that he was required to divest as part of the confirmation process.