

April 12, 2007

## **Brief Overview of Final Section 409A Rules**

On April 10<sup>th</sup>, IRS and Treasury released a 400-page package containing final regulations interpreting the rules of Code section 409A. The regulations finalize rules contained in the October 2005 proposed regulations on the scope of section 409A, as well as the rules for deferral elections and distributions under plans subject to section 409A. The final regulations are responsive to many of the comments filed on the proposed rules, but do not vary substantially from the overall structure and content of the proposal. Here is a brief overview of the final package.

**1. Scope** – Except in the area of severance pay, the final rules do not materially narrow the scope of affected plans. Section 409A continues to apply to the vast majority of elective and non-elective deferred compensation, supplemental retirement and incentive programs and generally any other arrangements involving a deferral of compensation into a future year. Short-term deferrals where payout is made no later than 2½ months after the year in which vesting occurs, stock options and stock appreciation rights (SARs) that do not provide for discounts or deferral features, and restricted stock continue to be exempt.

**2. Compliance Dates** – As expected, the regulations do not extend the transition relief for section 409A compliance. Thus, full documentary and operational compliance is required on and after January 1, 2008. From January 1, 2005 through December 31, 2007, reasonable, good faith compliance with the statute and certain IRS Notices is acceptable. Compliance with the proposed or final regulations is not required for good faith compliance prior to 2008, but compliance with the proposed or final regulations will be deemed good faith compliance.

**3. Required Documentation** – The final rules require, at a minimum, that the written plan documents specify the amounts being deferred (or formula), the time and form of payment (including the 6-month delay for payments to "key employees" of public companies on account of separation from service), and the conditions under which initial or subsequent deferral elections may be made. These may be in one or more documents (e.g., deferral election form, plus another document).

**4. Severance Pay** -- The final rules clarify that the 2 times pay (up to the statutory compensation limit, currently \$225,000 for a total of \$450,000) exemption for severance payments following an involuntary separation (or under a "window program") applies to payments up to the limit. Amounts payable in excess of the limit are not exempt from the section 409A rules (e.g., from the 6-month delay rule for "key employees"). "Good reason" terminations may be considered involuntary if certain requirements are met under either a facts and circumstances test or safe harbor exemption. Thus, arrangements providing for payments on a good reason termination may be eligible for either the 2 times pay or short-term deferral exception.

**5. Executive Medical, Gross-Ups and Other Post-Termination Benefits** – The final regulations generally restrict the exception for certain in-kind benefits and reimbursements to a period of 2 years after the year of separation from service (although reimbursements may be made for up to 3 years after the year of separation as long as the expense was incurred within the 2-year period). Under the final regulations, taxable reimbursements of medical expenses are exempted during the period of time during which the individual would have been entitled to COBRA continuation coverage. The final regulations do, however, provide an exemption for certain indemnification arrangements as well as helpful guidance on how reimbursement and in-kind benefits that are subject to section 409A may be designed to comply with section 409A, including payments of tax gross-ups.

**6. Supplemental/Mirror Plans** – The final rules generally do not provide more flexibility in this area. Thus, nonqualified mirror plans generally must continue to provide for elections independent of the underlying qualified plan. As expected, the final regulations do not extend the transition relief allowing distribution elections under qualified plans to control distributions under nonqualified plans (so called "piggyback elections"). The regulations do, however, provide helpful clarifications regarding the exception to the subsequent election rules for a choice between actuarially equivalent life annuity forms of payment. This exception should be helpful as employers redesign piggyback SERP arrangements.

**7. Service Recipient Stock Expanded** — The final regulations helpfully expand the definition of "service recipient stock" for purposes of the exceptions to 409A for certain stock options and SARs. Now, service recipient stock generally includes any class of common stock -- whether or not the stock is publicly traded or has the highest aggregate value outstanding -- of the corporation for whom the employee is performing services or any corporation in the controlled group "chain of organizations" above such corporation. This means generally that stock options or SARs may be granted to an employee based on the stock of the subsidiary for which the employee performs services or the stock of the parent of that subsidiary. Service recipient stock must not include preferences (other than liquidation rights).

**8. Option Exercise Extensions** – The final regulations provide that the exercise period of a stock option or SAR may be extended up to the end of the original term of the option or SAR (up to a maximum of 10 years from the date of grant) without the extension being treated as an additional deferral feature that would cause a violation of section 409A. Also, the final regulations include a new exception for the extension of stock options that are "underwater."

**9. 30-Day Rule for New Participants** -- The regulations improve the exception under which a newly eligible participant may make an initial deferral election within 30 days after the employee first becomes eligible to participate in the plan in a number of ways. In the case of a nonelective excess benefit plan, an employee may be treated as newly eligible to participate as of the first day of the year after the first year the employee accrues a benefit under the plan (and to apply the election even to benefits for services before the election).

**10. Deferral of RSUs and Similar Awards** – The proposed regulations included a special deferral election rule under which, in the case of certain compensation subject to a forfeiture condition requiring services for a period of at least 12 months (e.g., restricted stock units), an initial election may be made no later than 30 days after the date of grant, provided the

election is made at least 12 months in advance of the earliest vesting date. Under the final regulations, this rule is available even if the right to the compensation may vest earlier than 12 months following the election due to death, disability or a change in control, provided that if one of these events occurs before the end of the 12-month period, the deferral election may be given effect only if it is otherwise permissible.

**11. "Key Employee" Determinations** -- Payments to key employees of public companies on account of a "separation from service" must be delayed for at least 6 months after separation. The final regulations include more flexible rules regarding identifying the group of employees to whom the 6 month-delay applies, including allowing employers to apply the delay to all employees or an objectively determined group of up to 200 employees – even though no more than 50 employees may be treated as "key employees" under the "officer" prong of the definition. The final regulations also include significant changes to the rules for determining key employees after a spin-off, merger or other corporate transaction, including that no more than a total of 50 employees of the post-transaction entity/entities are required to be treated as key employees.

**12. Future Guidance** -- Future guidance will be issued on the W-2 reporting requirements, the 409A penalty provisions, the funding restrictions under section 409A(b), and other matters.

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

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