Snell & Wilmer L.L.P.

EMPLOYEE BENEFITS UPDATE

www.swlaw.com

April 2007

CONTACTS

THOMAS R. HOECKER
602.382.6361
thoecker@swlaw.com

MARVIN S. SWIFT, JR.
602.382.6211
mswift@swlaw.com

NANCY K. CAMPBELL
602.382.6374
ncampbell@swlaw.com

DENISE L. ATWOOD
602.382.6297
datwood@swlaw.com

ANNE M. MEYER
602.382.6595
ameyer@swlaw.com

MEGAN R. THIEL
602.382.6523
mthiel@swlaw.com

SARA R. VAN HOUTEN
602.382.6342
svanhouten@swlaw.com

IRS Releases Final Regulations Regarding Nonqualified Deferred Compensation Plans

COVERED PLANS MUST BE AMENDED BY YEAR-END

In late 2004, Congress added new Section 409A to the Internal Revenue Code to deal with perceived abuses involving "nonqualified deferred compensation plans." Section 409A became effective as of January 1, 2005. Proposed regulations were released in late 2005 and on April 10, 2007, the IRS finally published the long awaited, final regulations.

Employers have until December 31, 2007 to amend all of their nonqualified deferred compensation plans to comply with the new rules. Failure to timely amend plans will result in disastrous tax consequences for covered executives and employers will be required to withhold for taxes resulting from the non-compliance.

The final regulations closely follow the proposed regulations. We suspect that we will be discovering nuances in the final regulations for months to come, but our initial reading of the final regulations (which along with the explanatory preamble total nearly 400 pages) suggests that the final regulations provide needed clarifications and relief in a number of areas. The most significant changes made by the final regulations, as gleaned from our initial reading, are these:

- The exception for short-term deferrals is liberalized, making it potentially available even if an agreement permits a voluntary termination for "good reason."
- The rules for identifying "specified employees" (who must wait six months to receive payments due to a separation from service) have been liberalized.

- The separation pay exception has been expanded to permit voluntary "good reason" terminations in certain circumstances.
- The plan aggregation rules have been expanded to ease noncompliance consequences.
- The definition of "service recipient" has been expanded to make granting compliant stock rights easier.
- There is increased flexibility to extend the exercise period for stock rights.
- Providing post-termination in-kind and medical benefits is simpler.

A more thorough explanation of the changes made by the final regulations follows.

Coverage. Section 409A applies to any "nonqualified deferred compensation plan." A "nonqualified deferred compensation plan" is an arrangement under which an employee obtains a legally binding right in one year to receive payments in a later year. These new rules apply to traditional deferred compensation programs, SERPs, severance agreements, many different forms of equity based compensation arrangements (including certain stock option and stock appreciation rights, phantom equity programs, and restricted stock units) and certain other arrangements. The reach of Section 409A also is subject to a number of exceptions.

- It was unclear under the proposed regulations whether post-termination indemnification arrangements entered into between an employer and an employee would be treated as deferred compensation subject to Section 409A. The final regulations provide that typical post-termination indemnification arrangements will not be treated as deferred compensation subject to Section 409A.
- Under the final regulations, settlements of bona fide legal claims for wrongful termination, employment discrimination, etc., are not automatically subject to Section 409A. If the settlement agreement calls for deferred payments, though, Section 409A may apply.
- Under the final regulations, Section 409A does not apply to educational benefits that consist solely of educational assistance.
- Payments made under a medical reimbursement program that are taxable to the employee do not qualify for the Section 409A welfare plan exception and are subject to Section 409A. Other changes in the final regulations, which are described below, lessen the impact of this change.
- Section 409A does not apply to the grant of restricted stock. The final regulations clarify that a right to receive restricted stock (or other non-vested property) in a future year is not deferred compensation subject to Section 409A. However, the current right to receive vested property in a future year is deferred compensation subject to Section 409A. For example, on the one hand, the right under a restricted stock unit arrangement to receive stock subject to forfeiture provisions would not be subject to Section 409A. On the other hand, the right to receive unrestricted property in a future year would be subject to Section 409A.

Short-Term Deferral Exception. One of the most important exceptions to the requirements of Section 409A is the so called "short-term deferral exception." Under the short-term deferral exception, if payments are made to an employee[1] within the "short-term deferral period," the payment is excluded from the reach of Section 409A. The "short-term deferral period" is the two and one-half month period following the later of the calendar year or the employer's fiscal year in which the employee's right to receive the payment is no longer subject to a substantial risk of forfeiture. For example, if an employee acquires a vested right to receive compensation in calendar year 2007, and the employer's fiscal year is the calendar year, the short-term deferral period ends March 15, 2008.

- The proposed regulations included a provision that permitted delays beyond March 15 if the delay was due to an unforeseeable event. The final regulations liberalize this standard and also provide that a payment may be delayed if the payment would jeopardize the employer's ability to continue as a going concern.
- Under the proposed regulations, a payment conditioned on an employee's "involuntary" termination was treated as being subject to a substantial risk of forfeiture, making the short-term deferral exception available. The proposed regulations suggested that if a severance or change of control agreement conditioned payments on an employee's voluntary termination for "good reason," no substantial risk of forfeiture existed. As a result, the short-term deferral exception would be arguably unavailable.
- Under the final regulations, under certain circumstances, a voluntary good reason termination can be treated as an involuntary termination and may be eligible for the short-term deferral exception.

Stock Rights. The proposed regulations provided that options and stock-settled stock appreciation rights granted at fair market value were not considered deferred compensation subject to Section 409A. This exception applied if the option or SAR related to the grant of "service recipient stock." The proposed regulations narrowly defined what stock would be treated as service recipient stock.

- The final regulations expand the classes of stock that qualify as service recipient stock to include any class of common stock of any corporation in a chain of organizations, all of which have a controlling interest in another organization, beginning with the parent organization and ending with the organization for which the employee provides services. In other words, service recipient stock includes the common stock of any organization "up the employer's chain" but not "down the employer's chain."
- In addition, the final regulations lower the percentage ownership interest threshold from 80% to 50% in defining controlling interest (when looking up and down the chain of organizations) and keep the lower 20% threshold if based on legitimate business criteria. The criteria focuses on the relationship between the

[1] Section 409A actually applies to any employee or other person who is providing services. The term used in the regulations is "service provider." For ease of reference, we will refer to all service providers as "employees."

employee and the organization granting the option.

- The final regulations keep the basic requirement that the fair market value exercise price must be based on the reasonable application of a reasonable valuation method. The final regulations also keep the safe harbor valuation methods for private companies introduced by the proposed regulations with certain minor changes. However, the final regulations do make it clear that an independent valuation is not required for an acceptable private company valuation.
- The consistency requirement in the proposed regulations is eliminated and different valuation methods can be used for different purposes so long as each method otherwise meets the requirements in the final regulations.
- The final regulations expand an employer's ability to extend the exercise period of a stock right without creating a "material modification." The exercise period of stock rights may be extended until the earlier of ten years from the date of grant or the original term. In addition, the term of so-called "underwater" equity rights may be extended.

Severance Arrangements. The proposed regulations made it clear that Section 409A applied to severance arrangements (which the regulations refer to as "separation pay arrangements"). The final regulations continue this general approach. Some of the most difficult Section 409A issues arise in the context of severance arrangements.

- Like the proposed regulations, the final regulations provide an exception to the requirements of Section 409A for severance payments made following an involuntary termination or participation in a window program. To qualify for this "separation pay exception," the payments must end by the end of the second calendar year following the year of separation from service. The payments also must be limited to an amount that is equal to the lesser of two times the employee's annual rate of compensation or two times the limit specified in Section 401(a)(17) of the Internal Revenue Code (2 x $225,000 for 2007).
- In a dramatic improvement over proposed regulations, the final regulations make it clear that even if the total severance payments exceeds the two times limit (e.g., $450,000 in 2007) the first $450,000 can qualify for the separation pay exception. Only the excess over the limit ($450,000 in 2007) will be subject to Section 409A. This change is extremely important for certain officers and shareholders of a publicly held company who may not receive any payments until six months following their separation from service. These individuals now may receive up to $450,000 (in 2007) during this initial six-month period, assuming the other requirements for the separation pay exception are met. (Note that the excess also might be excluded from the reach of Section 409A if the short-term deferral exception is available.)
- The separation pay exception only applies in the case of an "involuntary termination." Many severance arrangements permit an executive to voluntarily terminate employment for "good reason" and receive severance pay. As already noted, the proposed regulations suggested that a voluntary termination for "good reason" would not be treated as an involuntary termination for purposes of the separation pay exception. The final regulations permit certain voluntary good reason termina-

tions to be treated as involuntary separations. The good reason definition must require a material negative change in the employment relationship and, importantly, must include an opportunity for the employer to remedy the condition. The final regulations also provide a "safe harbor" definition of good reason that will likely become the standard.

- Employers commonly allow employees to resign rather than be fired. It was unclear under the proposed regulations whether this common practice resulted in characterizing the termination as voluntary rather than involuntary, making the separation pay exception unavailable. The final regulations clarify that whether a particular termination is voluntary or involuntary is determined on the basis of all the facts and circumstances, provided that the parties' characterization of the termination will be presumed to be correct. This presumption can be rebutted by showing that absent a voluntary separation the employee would have been fired.
- Severance arrangements often provide that the employee will be entitled to continue to be reimbursed for certain expenses following separation from employment. Under the proposed regulations, medical expenses could be reimbursed under the separation pay exception until the end of the second calendar year following the calendar year in which an employee terminated employment. The separation pay exception included in the final regulations permits medical reimbursements only as long as the employee would be entitled the coverage under COBRA. Although this change appears to be a cutback, another section of the regulations permits the reimbursement of medical expenses for an unlimited period. As a result, the final regulations actually improve the ability of a severance arrangement to provide for continued medical care. The reimbursements for the medical expenses, however, must comply with the requirements of Section 409A (i.e., they do not qualify for the separation pay exception).
- The final regulations exempt from Section 409A any separation pay up to a certain limited amount ($15,500 for 2007).

Plan Aggregation. The proposed regulations introduced a "plan aggregation" concept and divided plans into four separate categories, such as account balance plans, non-account balance plans, certain separation pay arrangements, and other plans. All plans of the same type in which an employee participates are treated as one plan. If any one of those plans violates Section 409A, adverse tax consequences apply to all amounts deferred under all plans of the same type.

- Improving on the proposed regulations, the final regulations add three new categories of plans – split-dollar life insurance arrangements, reimbursement plans and stock rights.
- The final regulations also provide that account balance plans must be subdivided into elective plans and non-elective plans. A right to receive a match on an elective deferral is not treated as an elective deferral.
- The final regulations also require plans to be broken into component parts. As a result, what may appear to be a single plan might actually be two separate plans for purposes of the plan aggregation rules. For example, if a plan includes both an account balance as well as defined benefit features, the plan will be broken into two plans.

Written Plan Requirements. Nonqualified deferred compensation plans must comply with Section 409A in both form and operation. As a result, all nonqualified deferred compensation plans must be in writing.

- The final regulations prescribe the minimum contents of the plan document. For example, the plan document must specify, at the time an amount is deferred, the amount to which the employee is entitled and the payment schedule. A plan also must provide for the six month payment delay applicable to certain officers and shareholders of publicly held companies. A number of other requirements also must be reflected in the plan document.
- A savings clause, providing that the plan must be interpreted to comply with Section 409A, will not be effective to salvage a defective plan document.

Deferral Elections. Under Section 409A, if a plan allows an employee to voluntarily elect to defer the receipt of compensation, the employee's election, subject to certain exceptions, must be made before the beginning of the calendar year in which the compensation is earned.

- As a general rule, an employee's election to defer compensation must be irrevocable. The final regulations permit an employee to cancel a deferral election if the employee becomes disabled, as long as certain requirements are met.
- Commentators requested clarification regarding the timing of an election to defer a portion of a discretionary bonus if the right to receive the bonus did not arise until a year after the year in which the services were performed. Unfortunately, the final regulations require that even if the bonus is discretionary the employee's deferral election must be made before the year in which the bonus is earned.
- As an exception to this general rule, an employee who first becomes eligible to participate in a plan may make an election at any time within 30 days after the date he or she first becomes eligible to participate. Because of the plan aggregation rules described above, if an employer implements a new plan, and already has a plan of the same type, the initial deferral election rule is ineffective. The final regulations offer very little relief in this context.
- If an employer and an employee negotiate a severance arrangement following the employee's actual involuntary or voluntary separation from service, and the employee did not previously have a legally binding right to receive separation pay, the employee may make a deferral election at any time before the contract is signed. This new rule applies only if the employee did not previously have a right to receive severance pay.

Permissible Payment Events. Under Section 409A, a nonqualified deferred compensation plan may make a payment to an employee if the employee separates from service, dies, becomes disabled, or suffers an unforeseeable hardship. A distribution also may be made following a change in control of the employer or on a specific date or dates or pursuant to a fixed schedule set forth in the plan when the compensation is initially deferred. The requirement, as implemented by the proposed regulations, that payments that were not triggered by another permissible payment event be made on a specific date or pursuant to a specific schedule created unanticipated problems.

- Under the final regulations, a payment will be deemed to be made on the scheduled date if it is paid not earlier than 30 days before the scheduled date as long as the employee is not permitted to select the taxable year of payment.
- The final regulations also allow a plan to designate an entire calendar year, rather than a specific date, as the specified payment date. Under the final regulations, if a plan provides only for a calendar year of payment (e.g., the calendar year following an employee's separation from service), the payment may be made at any time during that year.
- Some arrangements provide that a payment will be made as soon as administratively possible following separation from service, but no later than a particular date (for example, the end of the short-term deferral period). Under the final regulations, this approach is not permissible, unless the period during which the payment may be made is restricted to a specific calendar year or the period is not more than 90 days and the employee cannot elect in which year the payment is made.
- The preamble to the final regulations specifically indicates that a payment scheduled to be made within 180 days of separation from service violates 409A because it does not specify the calendar year of payment and exceeds the 90-day period required by the final regulations.
- Under the proposed regulations, it was unclear whether tax gross-up payments could comply with Section 409A. The final regulations clarify that tax gross-up payments will comply with Section 409A if made by the end of the calendar year following the year in which the related taxes are paid.

Reimbursements. Under the proposed regulations, reimbursement arrangements posed special problems because it appeared that such arrangements might not satisfy the requirement that all payments (other than those triggered by separation from service, death, disability, change of control or unforeseeable emergency) be made on a specific date or pursuant to a set schedule.

- Under the final regulations, a right to reimbursement may satisfy Section 409A as long as certain requirements are met.
- Perhaps the most important form of reimbursement arrangement relates to medical expenses. Under the final regulations, medical expenses apparently may be reimbursed for an unlimited period of time. On the other hand, limitations may be imposed on the reimbursement of medical expenses.

Separation from Service. One of the permissible triggers for payments under Section 409A is an employee's "separation from service." The proposed regulations provided some fairly detailed rules regarding when an employee would be deemed to have "separated from service."

- Under the proposed regulations, plans were required to use a specific definition of "separation from service" and to treat all "separations from service" the same. This provision created certain problems in the context of transfers of employees between affiliates who are not members of the same controlled group of corporations or the same group of commonly controlled trades or businesses. The final regulations permit an employer to define "separation from service" in a more flexible manner, subject to a number of requirements.
- The proposed regulations made a distinction between whether a separation from service occurs if an employee continues to provide limited services as an employee or independent contractor. The final regulations provide a single, simpler standard when an employee continues to provide limited services to the employer either as an employee or an independent contractor. Although the rules continue to be fairly complex, they are somewhat more flexible than the rules included in the proposed regulations.
- If an employee of the seller transfers to the buyer in connection with a sale of assets, the employee has technically "separated from service" with the seller, triggering payments under nonqualified deferred compensation plans. The final regulations permit the seller and the buyer to agree that the employee has not separated from service and is not entitled to receive a distribution as long as certain requirements are met.
- If a subsidiary is sold to an unrelated party, the seller, or perhaps the subsidiary's employees, might prefer to make and receive distributions from nonqualified deferred compensation plans, since the employees are no longer employed by the same controlled group of entities. The final regulations do not permit a distribution in this situation.
- Employees who terminate employment may continue to provide services as a director. The final regulations make it clear that in this situation the employee will be considered to have separated from service, triggering a distribution. On the other hand, if a director is also providing services as an independent contractor, the director will not be deemed to have "separated from service" until the director discontinues providing services as both a director and an independent contractor.

Six Month Payment Delay. Payments to certain officers and shareholders of publicly held companies (who are referred to in Section 409A as "specified employees") made due to a separation from service must be delayed for six months following the separation.

- The final regulations provide additional rules for identifying employees to whom these special rules apply.
- One category of specified employees is an officer making in excess of a certain amount of compensation ($145,000 for 2007). The final regulations indicate that for purposes of determining an officer's compensation, an employer has considerable flexibility.

- Some employers may have difficulty in determining (and redetermining each year) the category of employees who are specified employees. To ease this administrative burden, an employer's plan may delay payments to all employees until six months following separation from service. Certain requirements must be met in order to use this exception.
- Under the proposed regulations, specified employees must be identified as of the first day of the fourth month before a particular 12 month period. For employers that can more quickly make this determination, the final regulations permit an employer to make this specified employee determination on any day on or before the first day of a particular 12 month period.
- The final regulations make significant changes to the rules applicable for purposes of identifying specified employees following a corporate merger, spin off or other transaction. A number of alternatives are available for identifying specified employees in these circumstances.
- The final regulations also provide certain default rules for purposes of determining specified employees.
- A plan may make distributions to a specified employee's beneficiaries, without regard to the six month delay, in the event of the employee's death. In the final regulations, the IRS refused to extend this treatment to intervening disability, unforeseeable emergencies or change in control events that occur during the six-month period.
- As clarified in the final regulations, the six month delay will not apply to reimbursements or in-kind benefits under the separation pay plan rules.
- Payments may be accelerated, even if an employee has terminated employment and not satisfied the six month delay, for domestic relations orders and certain other payments.

Different Times and Forms of Payment. Generally a plan must provide a specific time and form of payment with respect to each permissible payment event.

- The time and form of a separation from service payment may vary depending on whether the separation occurs (i) during a period (not to exceed two years) following a change of control event or (ii) before or after a specified date or before or after a combination of a specified date and a specified period of service.
- The final regulations also permit, subject to some limitations, an employee to designate different times and forms of payment based on the conditions of his or her separation from service.

Change of Control Event. Payments may be made following a change of control event as defined in the regulations.

- The proposed regulations introduced a definition of change of control. The definition included a change in the effective control of the corporation, which involved a change in the ownership of 35% of the corporation's stock. The final regulations lower this percentage threshold to 30%.
- The final regulations continue to provide that certain post-transaction payments (such as earn-out type payments) to employees comply with Section 409A if they are made under the same terms and conditions as apply to payments to the corporation's shareholders.

Under the final regulations, the payments must be made no later than five years after the transaction, provided that further delays may be permissible if a payment is subject to a substantial risk of forfeiture and the short-term deferral exception is satisfied.

Unforeseeable Emergencies. An unforeseeable emergency is a permissible payment event.

- The final regulations expand this distribution event by permitting a distribution if the employee's beneficiary incurs a hardship.

Delays in Payment. As a general rule a nonqualified deferred compensation plan must prohibit additional or further deferrals and must make payments on the dates initially prescribed.

- The final regulations permit delays in payment pursuant to pre-specified objective, nondiscretionary formulas related to the business performance of the employer. For example, payments in a particular year may be limited to a set percentage of cash flow. The arrangement must specify when the delayed payments will be made.
- A payment also may be delayed if the payment would jeopardize the employer's ability to continue as a going concern. Payments that would violate a loan covenant or similar contractual obligation could possibly fall into this category.
- Payments also may be delayed if necessary to avoid application of the deduction limitation (the $1,000,000 cap on compensation) prescribed by Section 162(m) of the Code. Certain limitations and restrictions apply to this special rule.
- Payments also may be delayed if the employer refuses to pay the amount or if the delay is inadvertent. The employee is obligated to seek payment, however.

Ban on Acceleration of Payments. A plan or arrangement subject to Section 409A must specifically preclude the acceleration of payments. The proposed regulations and the final regulations carve out a few exceptions to this general requirement.

- Under the final regulations, an employee may not be given discretion as to whether any of the exceptions will apply.
- A covered plan may accelerate the payment of benefits on a plan termination that satisfies certain requirements. Under the proposed regulations, this plan termination exception is applicable only if an employer did not establish a similar plan for five years after the termination. The final regulations reduce this five-year period to three years.
- Under the final regulations, the plan termination exception will not apply if the employer is having financial problems.
- As a general rule (and as provided in the proposed and final regulations), a distribution from a covered plan may be made upon a termination following a change of control event. Under the final regulations, all aggregated plans (e.g., all plans of the same type or category) must be terminated and distributed to use this exception.
- In the preamble to the final regulations, the IRS notes that a plan may be terminated if no

employee has any vested rights and all payments are forfeited. On the other hand, if the employee receives other taxable benefits, those benefits might be treated as payments under the plan.

- Nonqualified deferred compensation plans typically require employees to cease participating if they fall out of the category of employees who qualify as a member of a select group of management or highly compensated employees (a so-called member of a "top hat plan" group). In addition, some plans permit those employees to receive a distribution of their interest in a plan because they no longer qualify to be in this top hat plan group. Because of the lack of Department of Labor guidance in this area, the final regulations prohibit covered plans from making a distribution to employees solely because they fall out of the top hat plan group.
- If there is a dispute between an employer and an employee regarding the employee's right to receive payments under a plan, the employer and the employee may settle the dispute. The settlement could include the acceleration of payments as a lump sum. The acceleration will not be treated as a violation of Section 409A as long as the settlement involves a bona fide dispute as to the right to receive any amounts. Unless there is a substantial reduction in the amount paid to the employee, the payment will not be presumed to satisfy the requirements of this exception. A reduction that is less than 25% of the value of the deferred amount in dispute generally is not a substantial reduction.
- An employer may elect to cash out an employee's interest in the plan as long as the interest does not exceed the limitation on contributions to a 401(k) plan ($15,500 for 2007). Under the final regulations, these cash outs can be made even before an employee terminates employment.
- An acceleration of payments pursuant to a domestic relations order is permitted so long as the payments are being made to the employee's spouse and not the employee.

Changes in the Time and Form of Payment. Section 409A significantly limits the employee's ability to change elections regarding the time or form of payments from covered plans.

- The final regulations make it clear that neither the employee nor the employer may change the time or form of payment without satisfying the subsequent election rules included in Section 409A. For example, if an employee has elected to receive payments in installments, the employer may not simply unilaterally elect to pay the employee in a lump sum payment.
- The final regulations also clarify the rules regarding different actuarially equivalent forms of annuity payments. Generally, if two forms of annuity payments are actuarially equivalent (using consistent assumptions), the employee may choose between the available forms without having to satisfy the subsequent election rules. Certain subsidized joint and survivor annuities that are actuarially equivalent to other annuities also are subject to this rule.
- Under the final regulations, the addition of death, disability, or an unforeseeable emergency as a potentially earlier payment event is a permissible acceleration of payments. However, the addition of death, disability, or an unforeseeable emergency as a potentially later

payment event is an impermissible acceleration of payments. In addition, one permissible payment event may not be substituted for another permissible payment event without satisfying the subsequent election rule.

- The final regulations permit an employer to offset small routine debts against amounts payable under a nonqualified plan without violating the ban on acceleration of payments.

Transition Relief

- The final regulations are effective January 1, 2008. Until then, taxpayers may operate plans in good faith compliance with the statute, Notice 2005-1 and either the proposed or the final regulations.
- Pursuant to Notice 2006-79, covered plan documents do need to be amended to comply with 409A by December 31, 2007 and no elections can be amended to move amounts in or out of 2007.
- Stock rights granted before April 10, 2007 can comply with Notice 2005-1 or the proposed regulations for their term, even if they are unexercised after December 31, 2007 and the good faith valuation standard of Notice 2006-4 continues to apply for purposes of determining the fair market value of the exercise price. Stock rights granted on or after April 10, 2007 that remain unexercised after December 31, 2007 must comply with the final regulations.
- A reasonable, good faith interpretation of whether the six-month delay requirement applies for specified employees will be respected even if the payments continue on or after January 1, 2008.

Split-Dollar Life Insurance. The final regulations do not deal with so-called split-dollar life insurance arrangements. The IRS provided separate guidance with respect to the application of the requirements of Section 409A to split-dollar arrangements.

* * *