



# The Impact on Executive Compensation from the IRC Section 409A Final Regulations

*Presented by  
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# PRESENTER

Mark Baumann



# The good, the bad and the ugly!!

We've got until 2008 to comply with final regulations!

Yeah, but they're 180+ pages!!

But that's not the worst of it – some actions should be done by 12/31/07!



CLINT EASTWOOD  
ELI WALLACH  
LEE VAN CLEEF  
**THE GOOD - THE BAD AND THE UGLY**

# Goal – Action Plan



- Give you a form of Action Plan (see hand out)
- Give you basic knowledge to help you execute your action plan

# What should I do now?

- Step 1: Gather all “deferred compensation” arrangements covered by 409A – oral and written
- Step 2: Review arrangements for 409A coverage and compliance
- Step 3: Before the end of 2007, review and revise payment elections if:
  - payments due in 2008 are desired later, or
  - payments due after 2008 are desired in 2008
- Step 4: Before the end of 2008, amend arrangements as necessary to comply with 409A

# Overview

- What is 409A and why should we care?
- What plans and people are covered?
- What is not covered?
- Basic requirements
- Stock Options
- Deferrals & Payments
- Separation and Severance
- Action Plan Recap & Q&A

# What is 409A?

Not a “Chevy” V8



Not an all-purpose cleaner

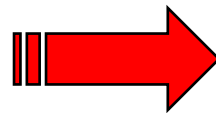


# What is 409A?

- Internal Revenue Code Section
- First effective in 2005
- Dictates timing of income tax on non-qualified deferred compensation
- How? By restricting the timing of deferrals and payments
- Why? Response to Enron debacle
  - “Some executives deserted the sinking ship”

# Why should we care?

## Premature taxation and penalties



# Why does a participant care?

- 409A restricts access to deferred compensation
- If 409A is violated, participant pays:
  - Immediate tax on vested deferred compensation
  - 20% penalty on vested deferred compensation
  - Interest to IRS, as if tax was due when vested compensation first deferred
  - If the deferred compensation is not vested, these taxes apply when vesting occurs
- Total taxes and interest may exceed 60% of deferred compensation

# Why does an employer care?

- Employer must report to IRS each year:
  - New deferred compensation for each participant
  - Any amounts taxable if 409A is violated
  - Corrections made during year under new procedure
- But reporting of new compensation is now delayed until rules are issued
- If executives or directors are penalized, they might blame the employer

# Action Plan – Step 1

- Find all “deferred compensation” arrangements covered by 409A – oral and written

# What is covered by 409A?

- “Non-qualified deferred compensation”
- “Non-qualified” means that tax-qualified benefit plans are not covered
- Non-covered plans will discussed later in this presentation

# Common examples of deferred compensation you may find:

- Voluntary deferral of salary or bonus – “Pay Me Now or Pay Me Later”
- Supplemental retirement plans
- Delayed bonuses and long-term incentives
- Severance benefit commitments
- Change in control payments
- Some stock options, stock appreciation rights and "phantom" stock
- Post-employment “executive perks”

# How can you identify “deferred compensation?”

- Legal right to compensation that could be paid later than the tax year it is earned
- Legal right exists even if compensation is forfeitable when conditions are not met
- This means the participant could sue if conditions are met
- So no legal right if compensation can be reduced by the employer alone
- Some exceptions may apply, as discussed later

# Who is covered by Section 409A?

- Employees
- Directors
- Partners (including members managing an LLC)
- Independent contractors
  - Exception if no customer uses over 70% of services
  - Safe harbor based on 3-year history
  - But no exception for management services

# How do you identify “new” deferred compensation covered by 409A?

- “New” deferred compensation is covered if:
- Earned after 2004, or
- Earned earlier, but first vested after 2004

# What do you do about “old” deferred compensation exempt from 409A?

- “Old” deferred compensation not covered if:
  - Earned and vested by the end of 2004
  - But a benefit was not vested in 2004 if it could be forfeited for competition or other reasons
- But “old” amounts become covered if rights are enhanced after October 2004
- So get advice before amendments

# What is not covered?

Qualified  
Plans

Short-  
term  
deferral

Welfare  
Plans



# What is not covered by 409A?

- Qualified retirement plans
  - 401(k), profit sharing, pension and ESOPs
  - 403(a) and (b) annuities
  - SEPs and SRAs.
  - 501(c)(18) plans
  - 457(b) plans of tax-exempts
  - 415(m) plans of governments
  - ERISA §1022(i)(2) plans
  - Certain foreign pension plans

# What is not covered by 409A?

- Bona fide welfare plans
  - Sick leave
  - Compensatory time
  - Vacation
  - Death benefit only
  - Disability benefit only
  - Non-taxable health and accident benefits
    - HSA
    - FSA

# What other benefits are not covered by 409A?

- Customary payroll practices
- Most stock options and stock rights
- Limited severance benefits
- Certain pre and post-separation reimbursement plans
- Non-taxable benefits including post-termination COBRA benefits if elected
- Educational assistance solely for employee
- Short term deferral of compensation

# What is a short term deferral?

- Payment on or before the last day of the applicable 2½ - month period (if no deferred payment option)
- Applicable 2½ - month period:
  - 15<sup>th</sup> day of 3<sup>rd</sup> month after the tax year of the employee or, if later, the employer's tax year
  - In which employee has both a:
    - legally binding right to a payment, and
    - any substantial risk of forfeiture has expired

# What is an example of a short term deferral?

- On November 1, 2007, Employer awarded an employee a legally binding right to a bonus that is not yet paid
- The bonus plan does not provide for a payment date or any option to defer payment
- The bonus plan will be exempt from 409A if the bonus is paid to the employee by March 15, 2008
- If paid later, the bonus is covered by 409A

# What is a “substantial risk of forfeiture?”

- Examples:
  - Employer’s unilateral right not to pay
  - Employment required on date of payment
  - Payment conditioned on involuntary separation from service without cause, unless the employee is in a position to prevent the separation

# What if I miss the short term deferral period?

- Violates 409A fixed payment date requirement, so
  - penalty, interest and taxes apply to vested amounts
- Exceptions if the date was specified:
  - administrative infeasibility
  - Payment risks employer's health as "going concern"
  - 162(m) deduction limitation

# Action Plan – Step 2

- Review all deferred compensation arrangements for coverage and compliance with 409A requirements

# What are the 409A requirements?

- Written plan by the end of 2008
- Good faith compliance in 2005-2008 with
  - Deferral Election Rules
  - Payment Rules (flexible transition elections)
  - Reporting Rules
- Full compliance with final regulations after 2008

# What is the “written plan?”

- All documents pertaining to the deferred compensation
  - Formal plan document
  - Deferral election forms
  - Employment agreements
  - Other compensation agreements
  - Arrangement may be in multiple documents

# Setting the stage – 409A may affect many forms of executive compensation:

- Stock-based compensation
- Supplemental retirement benefits
- Incentive compensation
- Elective deferrals
- Executive perks
- Change in control payments
- Termination benefits

# Exempt Stock-based Deferred Compensation

- Stock options or stock appreciation rights (SARs)
- Must use service recipient stock
  - But which entity is the service recipient?
    - Parent/Subsidiaries – 50% threshold
    - Joint Ventures – 20% threshold if legitimate business criteria
- Class of Stock
  - Common Stock
  - Some Preferred Stock
    - Liquidation preference permitted
    - Other preferential rights prohibited

# Stock Options

- Non-Discounted Stock Options/SARs
  - Exempt if exercise price not less than fair market value on date of grant
  - Fair market value
    - Public companies – market price of stock
    - Private companies – *reasonable* method *reasonably* applied by *qualified* person
      - Independent appraisal not required – clarified by final regulations
      - No Change in Control anticipated within 90 days
      - No Initial Public Offering anticipated within 180 days

# Stock Options

- Modifications/Extensions/Renewals
  - Modification of previous grant is a new deferral, but old price would violate exemption if value has increased
  - Extension of exercise period permitted if:
    - Extension is not beyond the *earlier* of (i) the original expiration date, or (ii) the 10<sup>th</sup> anniversary of the grant date or
    - Stock price is “underwater”
    - Important change from proposed regulations

# Deferral and payment elections

## Example: review of bonus contract

- Bonus is due 30 days after Change in Control or IPO that occurs while employed
- Is the bonus deferred compensation?
  - No, it is a short-term deferral
- What if bonus is due one year later?
  - It would be deferred compensation
  - But payment could not be based on IPO alone

# Example: New election to defer 20% of salary and bonus

- Can this election be made June 30, 2007?
  - Not for 2007 salary
  - Allowed for uncertain 2007 bonus
- Can deferred amounts be paid when child starts college?
  - No, not a permitted payment event
- What if child might never go to college?
  - Elect payment when the child turns 18, and allow election before age 17 to delay payment for 5 years

# Example: 45-year-old CEO's right to nonqualified pension at age 65

- Was it fully vested in 2004?
  - If so, old payment terms can be used
  - If not, must comply with 409A
- Can payment date be changed now?
  - Yes, in 2007 or 2008, because payment not due then
- How should payment schedule be changed for maximum flexibility?
  - Schedule payment at separation, unless election to delay
- What if CEO wants to delay payment later on?
  - Elect a year before payment is due, and delay 5 years

# What are the initial deferral rules?

- Timing of initial right to deferred pay:
  - Right to deferral must be final before employee's tax year when compensation will be earned
  - Includes voluntary and involuntary deferrals
  - Based on election, contract or plan
- No cancellation during that year
  - Unless disability or unforeseeable emergency

# Deferral timing exception

- New participants
  - May enroll within 30 days after eligibility
  - But only if not covered by a similar plan
- If pay measurement period has started, pro-rate compensation that can be deferred
  - Could avoid pro-ration by requiring one-year risk of forfeiture

# Other exceptions

- Performance-based compensation
  - Measured during at least 12 month period
  - Elect deferral at least 6 months before earned, if not then assured
- Fiscal year compensation (like performance-based)

# When are payments allowed?

- Six “sacred” payment times:
- Scheduled date or scheduled installments, or
- Five other permitted events:
  - Separation from service
  - Change in control
  - Disability
  - Unforeseeable Emergency
  - Death
- Events defined strictly (as discussed later today)
- No other events, such as an IPO

# How to avoid strict payment definitions

- If payment requires a separation from service after an earlier event (a “double trigger”), then
- The definition of the first “trigger” event need not comply with 409A
- Examples:
  - Change in control
  - Disability

# How can a plan add flexibility up front?

- Allow either one payment or installments
- Allow payment after earliest or latest of more than one of the permitted dates or events
- Allow different payment schedule if the event occurs before or after a fixed date or age
- If business is sold, require stock-based incentives to be paid on same terms received by shareholders
- A fixed formula may be used to limit or delay large payment amounts

# Six-month payment delay for “specified employee”

- Payments to a specified employee must be delayed for 6 months after separation
  - Applies only to public company, including
  - ADRs and stock traded on foreign exchanges
- Regardless of other payment terms
- Could avoid this by using short-term deferral exception for severance

# Who is a specified employee?

- Key employees (as defined in Section 416)
- Identified each 12/31 (earlier alternatives)
- Effective as of next 4/1 (earlier alternatives)
- Alternatives:
  - delay payments to all employees for 6 months
  - use over-inclusive method

# Who is a key employee at the end of 2007?

- Officer with annual pay over \$145,000
  - No more than 50 officers
  - Or, if less, the greater of 3 officers or 10 percent of the employees)
- More than 1% owner of the employer with annual pay over \$150,000
- More than 5% owner of the employer

# No acceleration of payments

- No one can have discretion to accelerate
- Even if participant accepts a discount
- Exceptions allowing early payment:
  - For FICA and some other taxes
  - Deferred compensation divided at divorce
  - Termination of all similar plans, with restrictions
  - Federal laws such as conflicts of interest rules

# Can payment terms be changed?

- Plan may allow the time or method of a scheduled payment to be changed, but:
  - Change cannot take effect for 12 months, and
  - Starting date must be delayed at least five years (except payments for death, disability or emergency)
- Payment terms can be changed in 2007 or 2008
  - Without those restrictions
  - Only if no payment is scheduled in the year the change is made

# How should a plan be designed for new payment rules?

- Many plans paid benefits at retirement age, unless the employer allowed early payment
- Plans should pay benefits at the earliest practical time, unless a participant (or the employer) timely elects a later time
- Allow participants to change current payment elections in 2007 or 2008 under transition rule

# Executive perks and separation from service

# CEO wants country club, company jet, and other perks while employed

- Must comply with 409A payment rule
- Fixed time for payment requirement satisfied if:
  - Objective coverage period
  - The expense reimbursements or benefits available in one year cannot affect the amount of reimbursements or benefits available in another year (exception for medical benefit caps).
  - The reimbursement must be made by the end of the employee's tax year after the tax year in which the expense is incurred.
  - Reimbursement or in-kind benefit rights may not be liquidated or exchanged for another benefit.

# Example

- Right to reimbursement of membership fees of up to \$30,000 over three years would not meet the requirement of a fixed time and form
- Why? All \$30,000 could be used in third year
- Right to be reimbursed for each year's expense (up to \$10,000) by end of next year would meet the requirements

# All good things come to an end

Sometimes for good reasons

Sometimes for bad reasons



# Does 409A affect post-separation benefits?

- YES!

# How does 409A affect post-termination benefits?

- Separation payments
  - Six-month delay rule
  - Exception for limited separation pay plan
- Executive perks
  - Expense reimbursements
  - Health benefits

# What is a separation from service?

- Not a change between employee and independent contractor (or partner) status
- Not a transfer within controlled group
- Requires at least 50% reduction in hours, if working after separation
- Working 20% or fewer hours is presumed to be a separation
- Plan may set hourly test between 20% and 50%, if based on a business reason

# What if service is in a dual capacity?

- If employee is also independent contractor for employer, must separate from service both as an employee and as an independent contractor
- However, if employee is a corporate director, service as a director ignored in determining whether separated from service as an employee

# What separation pay is exempt?

- Payments only upon involuntary separation from service (including separation for “good reason”) or participation in a window program
- Payable by the end of the second taxable year of the employee after the year of separation
- Limited to the lesser of:
  - two times the employee’s annual compensation or
  - two times the section 401(a)(17) limit (\$225,000 for 2007)

# What if the separation pay exceeds the dollar limitation?

- First \$450,000 (or two time pay, if less) remains excluded
- Excess must comply with 409A deferral and payment rules (especially six-month delay rule for specified employees)

# What is a separation for good reason?

- A material negative change in the employment relationship, such as material reduction of:
  - authority, duties, or responsibilities; or that of supervisor, including a requirement that a service provider report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation;
  - the budget over which the service provider retains authority;
  - conditions of employment, or
  - compensation to be received.

# What is the good reason safe harbor?

- Separation from service not more than one year after the initial existence of the good reason
- The amount, time and form of payment must be identical to an involuntary separation payment
- Notice to employer of good reason not later than 90 days after its initial existence
- Employer must have at least 30 days to cure

# What is an eligible post-termination reimbursement plan?

- Reimbursement of expenses due to separation from service, whether the separation is voluntary or involuntary.
- Expense incurred by service provider no later than the end of the second year after the separation
- Reimbursement must be done by the end of the third year after separation
- In-kind benefits must be provided by the end of the second year after separation.

# Examples

- Reasonable outplacement expenses and
- Reasonable moving expenses
  - loss incurred on sale of primary residence

# May 409A errors be corrected without full range of penalties?

- Limited corrections allowed under IRS Notice 2007-100 issued in December
- Not for intentional errors or payment made during employer's financial trouble
- Report to IRS required from employer and, in some cases, from employee

# How can payment errors be corrected in the same year?

- Adjust taxable compensation or get repayment in same year - no penalty or early taxation
- Interest may be paid on refund (must be paid on large refunds to insiders)
- Account adjustments allowed as soon as practical, if legal right to adjust exists by year-end
- Exercise prices on unexercised stock rights may be corrected in the year granted
- Special process if six-month delay not done

# What payment errors may be corrected in a later year?

- Error occurs before 2010,
- Amount does not exceed section 402(g) limit (\$15,500 through 2008)
- Failure to defer corrected within two years after year of error
- Excess deferral corrected within 2.5 months after discovery or, if later, within year of discovery
- Service provider's federal tax return is not being examined by IRS

# How are failures to defer corrected in a later year?

- Treat excess amount paid as taxable income when paid
- Excess amount (rather than entire deferred benefit) must be reported to IRS as subject to 20% excise tax in year of error
- Service provider must pay 20% tax for year of error

# How are excess deferrals corrected in a later year?

- Refund excess deferrals within 2.5 months after discovery or, if later, within year of discovery
- Refund may be adjusted for investment earnings (or loss) on the excess amount, or
- Investment earnings (or loss) may be removed from account
- Refund and any earnings reported as income taxable subject to 20% tax when received
- Service provider must pay 20% tax on amount received

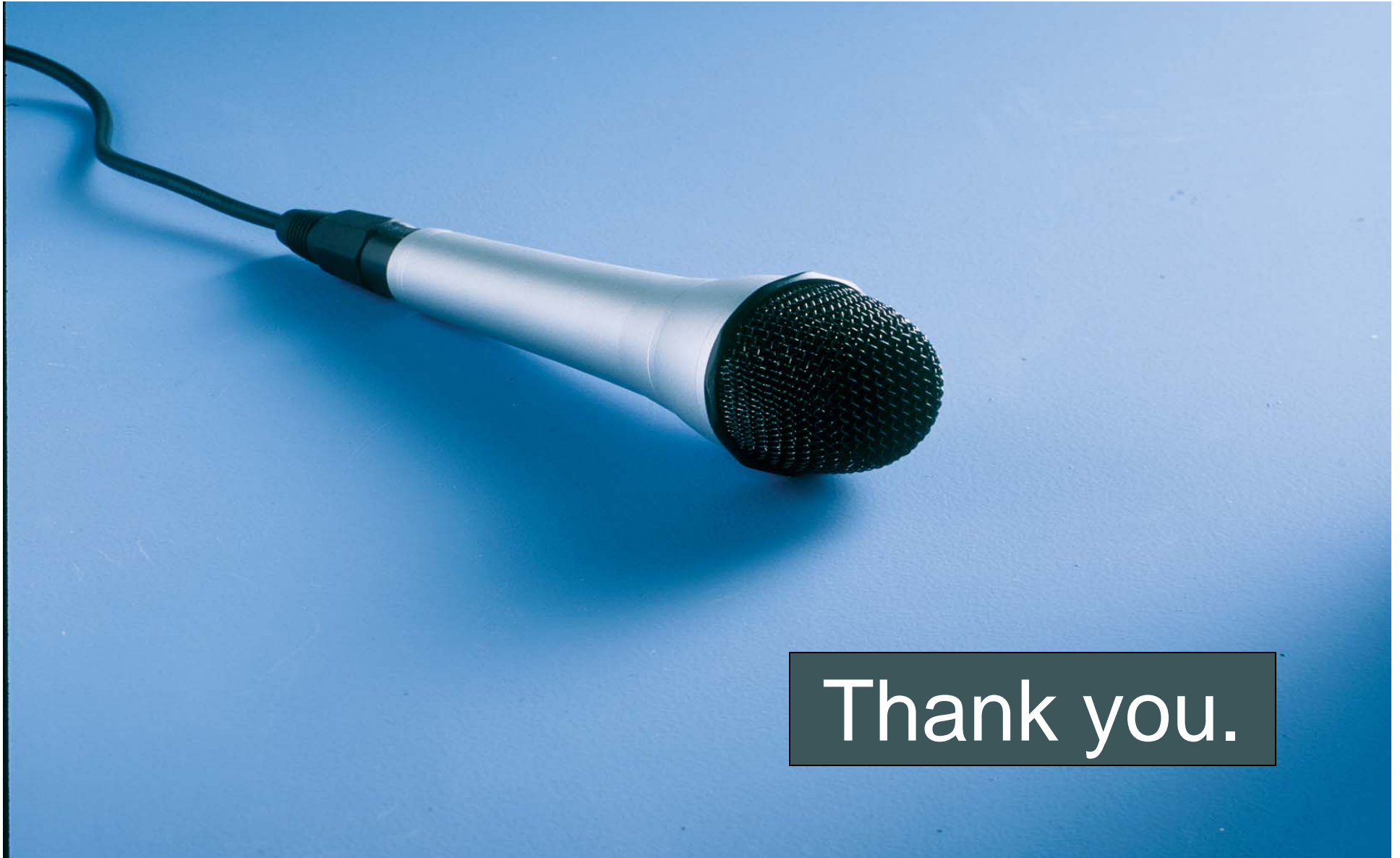
# Similar correction procedure is proposed for other 409A errors

- Amounts over \$15,500 could be corrected after year of error
- Excess payments would be returned by service provider and also reported and taxed, plus 20% penalty and interest, in the year of the error (but never taxed again)
- Excess deferrals could be refunded, but would be reported and taxed, plus 20% penalty and interest, in the year of the error (rather than the year refunded)

# Goal – Action Plan

- Give you a form of Action Plan (see hand-out)
- Give you basic knowledge to help you execute your action plan

# QUESTIONS/DISCUSSION



Thank you.

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