

A photograph of a silver and black microphone with a black mesh grille, positioned diagonally across a blue background. The microphone is connected to a black cable that extends from the top left corner.

What
matters.

A Maslon speaker series.

PAY ME NOW OR PAY ME LATER

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

Presented by

Attorneys from Maslon's Employee Benefits and Executive Compensation Group

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PRESENTERS



Mark Baumann



Alan Gilbert



Larry Koch



Martin Rosenbaum

Overview

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 - Why should I care?
 - What is “deferred compensation?”
 - What is a substantial risk of forfeiture?
 - What’s covered?
 - Who’s covered?
- **Larry Koch –**
 - What’s not covered?
 - What’s required?
 - What must a NQDCP contain?
 - Who is a specified employee?
- **Alan Gilbert –**
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 - Elective Deferrals
- **Larry Koch –**
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 - Separation from Service for “Good Reason”
 - Reimbursements
 - Severance benefits
- **Marty Rosenbaum –**
 - What should I do?
 - Q&A

What is 409A?

What is 409A?



What is 409A?



What is 409A?

- Tax law regarding the timing of the taxation of deferred compensation
- Response to Enron debacle

Why should I care?



Why should I care?

- 20% penalty on employee
- Interest and taxes from date of legal right
- Reporting requirement on employer
- Total tax bill in excess of 60% of payment

What is “deferred compensation?”

- Legal right to compensation that may be paid in a later tax year
- Even if subject to conditions precedent
- Not if subject to “substantial risk of forfeiture”

What is a “substantial risk of forfeiture?”

- Unilateral right not to pay
- No payment if terminated by employer without cause
- If have to be employed on date of payment to receive

What's covered?

- Deferred Compensation payable on and after 12/31/04
- Even if subject to forfeiture
- Not if employer has unilateral right to change or not pay

Who's covered?

- Employees
- Directors
- Independent contractors
 - Exceptions
 - Safe harbor

What's not?

- Qualified plans
 - 401(k)
 - Psp
 - Cash balance
 - 403(b) annuities
 - 457(b)
- Welfare plans
 - Death
 - Disability
 - Health and accident plans

What's not?

- Payroll practices
- Short term deferrals
- FMV Options and stock rights
- Certain severance arrangements
- Non-taxable benefits

What's required?

- Written plan
- Fixed payment date or schedule or payments upon certain permitted events: Death / disability (defined) / change of control (defined) / separation from service (defined)
- Fixed amount or amount determined by non-discretionary formula
- Elections due by end of year prior to year of service on which payment are based
- Limited ability to change date/schedule or method of payment

What must a written plan contain?

- Fixed time or schedule of payment
- Permitted payment event
- 6 month delay rule for specified employees of public company
- Fixed amount or amount determined by non-discretionary formula

Who is a specified employee?

- Top 50 highest paid employees
- Probable

What are some examples?

Stock Options

Stock Options: Contemporaneously with the execution of this Agreement, Executive shall receive stock options pursuant to the Company's 2004 Employee Stock Option Plan for 50,000 shares of common stock at an exercise price to be determined based on the fair market value of the Company's stock at the time of the grant. These options shall vest over three years with 25% vesting immediately, and 25% vesting for each completed year of service thereafter.

Stock Options

- Exempt if exercise price is not less than FMV on date of grant
- FMV:
 - Public companies – stock trades
 - Private companies – reasonable method reasonably applied by qualified person
 - No COC anticipated within 90 days
 - No IPO anticipated within 180 days
 - Independent appraisal not required

Bonuses

- Bonus
 - If at any time during the Original Term of this Agreement, the Company consummates an initial public offering or a Change of Control Event occurs, Executive shall also be entitled to a bonus (“Bonus”) of \$50,000, payable within 30 days after the consummation of the initial public offering or the Change of Control Event.

Salary Increases

- Base Salary

- If at any time during the Original Term of this Agreement, the Company consummates an initial public offering or a Change of Control Event occurs, Executive's Base Salary shall automatically increase to \$240,000 per annum, effective at the beginning of the next full calendar month following consummation of the initial public offering or the Change of Control Event. For purposes of this Agreement, a "Change of Control Event" shall mean the transfer of ownership of at least 50 percent of the shares of the Company entitled to vote for directors.

Salary and Bonus Deferrals

- Deferrals.

- The Executive may defer the receipt of up to 50% of his or her base salary and 100% of his or her Bonuses as provided in the XYZ Corporation Non-qualified Deferred Compensation Plan.

Salary and Bonus Deferrals

- Election – irrevocable as of end of year preceding the year in which the services to which the salary and bonuses pertain
- Example
- Exception – 30 days after becoming eligible – only if not covered by a similar plan
- Similar plans

Salary and Bonus Deferrals

- Election – irrevocable as of end of year preceding the year in which the services to which the salary and bonuses pertain
- Example
- Exception – 30 days after becoming eligible – only if not covered by a similar plan
- Similar plans

Reimbursements

- Expenses:
 - In accordance with the Company's policies, Executive shall be reimbursed by the Company for any and all reasonable business-related expenses incurred by the Executive on behalf of the Company.

Separation from Service

Executive rights upon without Cause termination or Constructive Termination:

If the Company terminates Executive's employment without Cause or upon "Constructive Termination," Executive shall, in exchange for executing a standard release governing the employment aspects of Executive's employment, (i.e., not releasing any claims arising from Executive's status as a shareholder):

- (i) continue to receive his Base Salary for a period of 12 months from the date of termination;
- (ii) receive his pro-rata portion of his Non-Discretionary Bonus payable as provided above;
- (iii) have all unvested portions of options issued pursuant to Section 3(f) hereof immediately vest. All options shall be exercisable for a period of 90 days from the date of termination if the Company has not consummated an initial public offering and for 180 days from the date of termination if the Company has consummated on initial public offering;
- (iv) receive a continuation of benefits paid for by the Company for twelve months following termination; and
- (v) be reimbursed for business expenses through termination of employment as provided herein.

What is a separation from service?

Death or Disability

- Termination for Death or Disability
 - This Agreement terminates upon the death or disability of Executive. For purposes of this Agreement, “disability” is defined to mean Executive’s physical or mental impairment that precludes his performance of all or substantially all of the duties of his position, with or without reasonable accommodation, for 26 consecutive weeks. Company will provide the Executive with 30 days advance notice of its intention to terminate this Agreement in the event of the Executive’s disability.
 - Upon termination of this Agreement by reason of death or disability of the Executive, the Company shall: (i) continue to pay the Executive (or his estate, as appropriate) for a period of six (6) months from such a date of termination an amount equal to 65% of the Executive’s Base Salary as in effect at the termination, as such is calculated and paid pursuant to Section 3a of this Agreement; and (ii) pay the Executive a pro-rata amount of Executive’s Non-Discretionary Bonus.

Death Benefits – Stock Options

- In addition to the foregoing, in the event of termination due to death or disability of the Executive, any stock options in the Company held by such Executive shall continue to vest pursuant to the schedule, and subject to the stock option agreement as if such a termination had not taken place. In the event of termination due to death, any stock or stock options in the Company held by the Executive at the time of his death may pass pursuant to the Executive's will or (if applicable) by intestacy, subject in all respects to any stockholders' agreement or other similar document in effect at the time of the Executive's death.

Non-discretionary Bonuses

- The Executive shall be entitled to a non-discretionary Bonus of up to 70% of the Bonus which such non-discretionary bonus shall be determined as follows:

What should I do?

- Implement an action plan (see handout)
- Gather all “deferred compensation” arrangements – oral and written
- Have all such arrangements reviewed for coverage and compliance
- Amend arrangement as necessary to comply with 409A on or before 12/31/2007
- Have all “elections” reviewed and revised as necessary on or before 12/31/2007

Don't let this happen to you



QUESTIONS/DISCUSSION



Thank you.