



April 11, 2007

Summary of Section 409A Regulations

We have been studying the 398-page final regulations released under Code section 409A, which will be published in the Federal Register on April 17, 2007. In general, the final regulations do not depart from the basic design and approach that was set forth in the proposed regulations. All NQDC plans, including elective plans, nonelective plans, and defined benefit SERPs must meet the timing of deferral rules and must include a specified payment date that meets the 409A standards. There are, however, numerous modifications, clarifications and, in some cases, more detailed rules in the final regulations that will affect many different types of plan designs. While we intend to provide more detailed analysis over the next few weeks, we have the following initial observations on the items in the final regulations that are likely to have broad application to employers and service-providers:

1. *“Service recipient stock” definition expanded.* The final regulations provide that any common stock of a service-recipient company or its parent or subsidiary in the controlled group may be used for an option or SAR, provided that the common stock does not include payment preferences (other than a liquidation preference). This means that even if a public company is in the controlled group, an employee may receive an option or SAR on the common stock of a nonpublicly traded company (or its parent or subsidiary) for which the employee performs services.
2. *Fair market value.* The final regulations continue the requirement that the exercise price of an option or SAR that is not subject to 409A be no less than the fair market value on date of grant. The final regulations reject the adoption of the “ISO” rule, which would provide for any “good faith” valuation method. The final regulations continue with some modification the three “presumptive” safe harbors with respect to the valuation of nonpublicly-traded stock (*i.e.*, independent appraisal, section 83 “non lapse” formula, and valuation by a qualified person for a start-up company). The start-up company presumption is modified to exclude any change in control that is not reasonably anticipated to occur within 90 days or any initial public offering that is not reasonably anticipated to occur within the next 180 days. The final regulations also clarify the application of the “30-day pricing” exception for options and SARs issued on publicly-traded stock and state that the number of shares and the 30-day period over which the price will be determined must be established prior to the start of the 30-day period.

3. **Dividends.** The final regulations continue to treat deferred dividend payments as separate arrangements from the underlying option or SAR, which must either separately meet the 409A rules or satisfy one of the 409A exceptions.

4. **Modifications and extensions of exercise period.** The final regulations adopt many of the comments requesting that an extension of the exercise period not be treated as a modification of the option or SAR. The final regulations provide this relief as long as the extension does not exceed the end of the original option period (not to exceed 10 years). “Underwater” options and SARs may be extended and will be treated as a new grant (that would presumably meet the 409A exception since the option price would be lower than the fair market value on the new grant date).

5. **Short-term deferral (e.g., “vest and pay”) rule.** The final regulations retain this helpful exception but make clear that it only applies where, by the terms and the operation of the arrangement, payments are always due in the calendar year or no later than 2-1/2 months following the vesting event. The exception does not apply to “coincidental” payments upon vesting. For example, an amount that becomes payable upon separation from service does not satisfy the exception merely because the employee separates and is paid in the same tax year that vesting occurs (or within 2-1/2 months) if, under the terms of the arrangement, the amount would not have been payable upon vesting had the employee continued working.

6. **Separation pay.** The final regulations include a number of changes that are relevant both to the “separation pay” exceptions from 409A and the application of the short-term deferral exception to amounts paid upon a separation. The final regulations clarify that the exception from 409A for certain separation pay upon an involuntary termination (or a window program) applies *to the extent* that amounts do not exceed 2 times pay (up to 2 times the 401(a)(17) limit). Thus, the limit is an exclusion and not a “cliff” and separation pay up to the limit is excepted from 409A while the amounts in excess of the limit are subject to the 409A rules, including the 6-month delay for specified employees (unless the payments meet some other 409A exception).

7. **“Good reason” terminations.** The final regulations respond to requests for guidance on the types of “good reason” provisions that may result in separation pay being subject to a substantial risk of forfeiture. The final regulations define good reason under a facts and circumstances test and also provide a safe harbor for payments meeting certain criteria (e.g., payments triggered by a material diminution in duties, compensation, or authority) that are made no later than one year following the “good reason” and that are made under the terms of an arrangement where the service recipient has the opportunity to remedy the good reason condition after it is declared by the employee. If there is “good reason,” then amounts that arise on account of such termination are “involuntary” (but not including amounts that would be due to the employee regardless of the good reason termination). Such payments on an

“involuntary” termination may satisfy the separation pay exception discussed above or they may satisfy the “vest and pay” exception, depending upon the design of the arrangement.

8. *Performance-based NQDC.* The final regulations clarify that the special timing rules for deferral elections on performance-based compensation must be made prior to the date that the amount is “readily ascertainable,” as opposed to the “substantially uncertain” standard used in the proposed regulations. Nonetheless, the final regulations indicate that if some but not all the performance-based compensation becomes readily ascertainable because satisfaction of the goal is substantially certain then, as to those ascertainable amounts, the deferral election must be made at an earlier date when the standard can be met. The final regulations reject commentors’ requests that stock price be deemed a performance goal. Thus, a bonus that is a function of stock price (such as a stock right that for some reason does not meet the exception for options or SARs) will not automatically be performance-based and eligible for the more lenient deferral timing rules.

9. *Timing of deferrals for commissions and similar payments.* In response to comments, the final regulations expand the definition of commissions to include “investment commission income,” which generally can be deferred under an election filed prior the year in which such commission arises.

10. *Payments based on specified events and dates, including profit formulae or receipt of payments on accounts receivable.* The final regulations provide clarification on when a payment schedule meets the 409A standards and expand the rules for payments on a specified date to include payments based upon both a specified age and years of service (as determined under the plan.) The final regulations also respond to comments by allowing the timing of NQDC payments to be based upon an objective formula, such as profits, and the collection of the employer’s accounts receivable, provided that certain anti-abuse rules are met.

11. *No blessing for “payroll continuation.”* The final regulations do not provide any additional flexibility for treating an employee as not having separated from employment by virtue of salary or “payroll” continuation. Thus, employers will need to determine whether employees are actually performing services (as discussed in item 12 below) even if are continued on the payroll as a regular employee for some period of time.

12. *More flexibility to define “separation from service.”* The final regulations modify and generally liberalize the proposed regulations’ presumptive rules for determining when a reduction in services is a separation from employment. In general, the proposed regulations treat both employee and independent contractor service providers as being subject to the same rules and provide that an employee or independent contractor may be treated as having separated from service under 409A where the level

of services is reduced to a level that is expected to be no more than 20 percent of the level of services for the prior 36-month period. The final regulations also include a rule, in response to comments, that allows a plan to define a permanent reduction in services as a "separation" for purposes of making distributions from the NQDC plan. This permanent reduction must be at least a 50-percent reduction. The permanent-reduction-in-services rule should be beneficial for industries in which service providers tend to phase into retirement or continue performing services, albeit on a reduced level, into their traditional retirement years.

13. *Mergers and acquisitions.* The final regulations allow an employer to define the controlled group to include entities in which there is as little as a 20-percent ownership, provided that there is legitimate non-tax reason for doing so under 409A. The final regulations also allow an employer to treat an employee whose employer leaves the controlled group but who continues working at the "same desk" in an asset sale to be treated as having not separated from service even though the employee is no longer working for an employer in the controlled group.

14. *Determining "specified employees."* The final regulations provide more flexibility for defining the group of employees subject to the 6-month delay, including applying the delay to all employees, to a group of employees not to exceed 200, and determining the specified employees based on any definition of compensation that is allowed under section 415.

15. *Ethics payments.* The exception from 409A for accelerated NQDC payments to avoid ethics violations generally is expanded to include any federal, state or local law.

16. *Effective date.* The final regulations are effective as of January 1, 2008.