Final IRC Section 409A Regulations

Section 409A of the Internal Revenue Code made dramatic changes to the taxation of deferred compensation plans. Unless specifically excluded by statute or regulation, deferred compensation is broadly defined to include any deferral of compensation from the year in which the related services are performed to a subsequent year - even if the payment for such services is contingent - as well as “in-kind” benefits and reimbursements. With certain exceptions, the term “plan” is also broadly defined to include any agreement, method, or arrangement with a single employee, independent contractor or director of the service recipient. Based on this definition, a clause in an employment agreement with a single individual could constitute a “plan.” Severance payments, “change of control” payments and certain equity compensation grants (such as discounted stock options and discounted stock appreciation rights) can be treated as deferred compensation plans. Failure to comply with Section 409A could result in imposition of a 20% excise tax, early inclusion in deferred income, and interest on payments from “nonqualified” deferred compensation plans.

Generally speaking, under Section 409A, the service provider must make an irrevocable deferral election in his or her tax year before the tax year in which the services are performed and must specify the time and form of payment of benefits. A service provider is permitted to make a subsequent election to delay a payment or change the form of a payment (provided that any such payment is the subject of an initial deferral election) provided that certain conditions are met. Deferred compensation payments must be made upon a fixed date or under a fixed schedule, and may be made or may commence upon certain events: separation from service, death, disability, change in control, or unforeseeable emergency. “Key employees” of public companies cannot receive deferred compensation payments earlier than six months after the event triggering the payment (e.g., separation from service). Exceptions are provided for certain short-term deferrals and for payments of severance upon involuntary terminations (including certain terminations for good reason).

Although the penalties under Code Section 409A fall principally on executives, the companies that employ them will be required to report deferred compensation and to withhold taxes and to pay and remit employment taxes, and employers may face penalties if they fail to report and withhold on the proper amounts.

In April 2007, the IRS and the Treasury Department issued the final regulations interpreting Section 409A. The following aspects of the final regulations will be of interest to our clients:

- First, all compensation plans and agreements must be amended prior to January 1, 2008 to be in compliance with Section 409A. The final regulations generally provide that required plan provisions (amounts deferred, time and form of payment) must be in writing and in effect at the time an amount is deferred. The six-month payment delay requirement applicable to specified employees (generally, “key employees” of public companies) must be set forth in writing at the time the employee becomes a specified employee. General savings clauses will not be sufficient.

- In the case of an involuntary termination (including, under certain circumstances, a termination for “good reason”), a portion of a deferred compensation payment may be characterized as “severance” and therefore exempt from Section 409A (including the six-month delay on payments to “key employees” of public companies). The amount that may be treated as “severance” will be the lesser of (a) twice the employee’s annual rate of pay for the year prior to separation (adjusted to take account of increases during that year), or (b) for 2007, $450,000 (i.e., twice the IRC Section 401(a)(17) limit for the year of separation).

- A termination for “good reason” requires company action resulting in a material negative change in the employment relations (duties, conditions of employment, compensation). The final regulations provide a safe harbor (which should, if appropriate, be considered for inclusion in employment contracts) where all of the following conditions are satisfied: the separation from service must occur within a limited period of time (not to exceed two years) following the initial “good reason” condition, the amount, timing an form of payment upon a voluntary separation for good reason and an involuntary termination must be identical, the employee must provide notice of the existence of the "good reason" condition within a period not to exceed 90 days of the initial “good reason” condition, and the employer must have at least 30 days during which to cure the “good reason" condition.

- In the case of options granted at fair market value, the extension of a post-termination exercise period generally will not trigger application of Section 409A if the exercise period is not extended beyond the earlier of the original maximum term of the option or 10 years from the original date of grant of the stock right, or if the option is "out of the money" at the time of extension. (The mere exercise of an option granted at fair market value will not result in the receipt of deferred compensation subject to Section 409A).

- Employers should immediately identify all employment contracts, plans, agreements or other arrangements that could be subject to Section 409A. An analysis for compliance with the new rules should be made at the earliest opportunity.

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[1] To ensure compliance with requirements imposed by the IRS, we inform you any tax advice contained in this memorandum was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any-tax related matter addressed herein.