

TOP 10 THINGS TO KNOW ABOUT THE FINAL SECTION 409A REGULATIONS

1. There have been significant expansions to the definition of service recipient stock

Rule: The definition of service recipient stock has been expanded to include the 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 service provider was providing services at the date of grant. The final regulations lower the controlling interest ownership threshold from 80% to 50% and retain the 20% rule if there are legitimate business criteria, based on the specific facts and circumstances. The final regulations retain the restrictions on use of stock with any dividend preference. Service recipients are not required to make a specific election. Instead, whether the stock is service recipient stock is determined on a grant by grant basis.

Additionally, the stock may be based on any class of common stock within the corporate chain regardless of whether there is another class of stock that is publicly traded or has a higher aggregate value outstanding.

Effect: This change gives service recipients flexibility to determine the stock on which they will grant equity rights based on criteria other than trading availability and aggregate outstanding value. Caution should be exercised to ensure the general anti-abuse provision is not violated when selecting the service recipient stock on which to base grants.

In addition, transition relief provides that options granted during the transition period and prior to the date the regulations were filed can continue in effect under their terms, as long as the option was issued on stock that is “service recipient stock” under a good faith interpretation of the statute and applicable guidance.

2. There is now greater flexibility to extend the exercise period of equity rights

Rule: The exercise period of equity rights may be extended until the earlier of ten years from the date of grant or the end of the original maximum term of the option. In addition, the extension of an underwater equity right is permissible.

Effect: These changes provide service recipients the discretion to extend an equity right exercise period without causing the right to be considered as having an additional deferral feature from the date of grant. We expect extensions will most

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often be in situations where the service recipient wants to waive a provision that would require an individual to exercise an option shortly after separation from service, such as in connection with a reduction in force or business transaction.

3. Public and private companies should review the valuation criteria for establishing fair market value for equity rights

Rule: The regulations retain the basic standard that exercise price must be set by reasonable application of reasonable valuation method. The regulations do not incorporate the “good faith attempt” provisions under the ISO regulations. The three safe harbors available for private companies introduced in the proposed regulations are retained in the final regulations with minor adjustments, notably to the methodology for illiquid start-up companies. The final regulations confirm that the use of an independent appraiser is not necessary for an acceptable private company valuation. Additionally, it is not required that public or private companies use the same valuations method for establishing the exercise price and determining the fair market value at the time of exercise. Public companies that intend to use averaging for determining exercise price must make an irrevocable commitment to the averaging period before the beginning of the period.

Effect: Private companies will likely be relieved that an independent appraisal is not required to be in compliance with the valuation requirements, although many companies may still consider obtaining an independent valuation. Public companies may have to adjust their equity right practices to ensure their averaging period is committed to timely in accordance with the new requirements.

4. The rules address how to provide in-kind and reimbursement benefits

Rule: A number of different provisions address provision of in-kind and reimbursement benefits. First, a reimbursement arrangement or an arrangement for provision of in-kind benefits does not provide for deferral of compensation if it is provided on separation from service (voluntary or involuntary) and covers amounts excludible from income, that would be deductible business expenses, moving expenses, loss on the sale of a house, or outplacement expenses. Payments for medical expenses can be provided through the end of the COBRA period. The time for providing reimbursement is extended to the end of the third year after separation from service (provision of in-kind benefit is limited to the end of the second year after the year of separation from service).

Second, the rules provide that reimbursement arrangements that are deferred compensation satisfy the rules for a fixed schedule of payments if the provisions regarding eligible expenses and the time for reimbursement are objectively determinable, and reimbursements are made by the end of the year after the year the expense was incurred. In addition, reimbursements in one year cannot effect

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the amount eligible in another year, and the right to reimbursement cannot be subject to liquidation or exchange.

Effect: These two provisions address many of concerns about how to provide continued eligibility for post-employment reimbursements or in-kind benefits.

5. The regulations expand on what constitutes a “payment” and when delays are permissible

Rule: There are a number of provisions related to payments and delays that address taxpayer concerns. The regulations apply rules regarding timing of distribution and the redeferral rules to each “payment” as defined in a plan. These can include each specific payment under a schedule, or the entire schedule of payments. This is particularly important in applying the short-term deferral exception, the redeferral rules, and new provisions addressing adding distribution events to a plan.

The rules also expand the situations in which payments may be delayed without violations of 409A, for example allowing delays if the payment would jeopardize the service recipient’s status as a going concern. In addition, the rules provide additional protection for service providers in situations in which a delay is the result of service recipient refusal to pay or delay in paying, as long as the service provider is engaged in ensuring a timely payment.

Effect: The rules on payments, changes in payments, and permissible delays in payments are complicated, but overall provide additional flexibility. The changes also should reduce the risk that an unanticipated or inadvertent delay will result in income inclusion and additional tax under section 409A.

6. The exception for short-term deferral is both expanded and limited

Rule: The short-term deferral exception covers amounts that are paid no later than 2 ½ months after the end of the year in which the right to a payment becomes vested. The final regulations clarify that this exception only applies if arrangement does not provide for a payment that could occur outside the short-term deferral period. A plan that is intended to fit short-term deferral can also comply with the rules of 409A, if the plan is in writing and the payment can not be made in more than one taxable year. Related guidance includes provisions allowing good reason clauses to create a substantial risk of forfeiture and on the payment by payment application of the rules

Effect: The short term deferral exception is applicable in many different situations, particularly with respect to long-term bonus plans and payments on an involuntary separation from service. For example, the rules will allow employers to provide payments that are available only on an involuntary severance to be

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made without the 6-month delay applicable to specified employees, even if other payments to be made to the same individual may be subject to the 6-month delay.

7. Additional rules are provided for defining specified employees

Rule: The final regulations include the ability to use an alternative method of identifying employees for whom distributions will be delayed for six months, provided the method does not allow for direct or indirect deferral elections. In general, the definition of specified employee looks to the definition of key employee under the qualified plan rules. For defining compensation, section 415 compensation – including amounts paid to a nonresident alien – can be used. A plan can also use alternative method for identifying specified employees if it is reasonably designed to include all specified employees, is an objectively determinable standard providing no direct/indirect election to any service provider regarding its application and results in no more than 200 service providers being identified as of any date. In addition, there are specific rules provided regarding the definition of these employees in the case of employers recently involved in a merger and acquisition transaction.

Effect: Many employers were concerned that the classification of an employee as a specified employee could be later determined to be erroneous and thus payments may not have complied with the required 6 month delay. These rules provide more certainty to that definition and also enable the employer to treat a broader group of employees as specified, an approach that will often help ensure that all specified employees comply with the rule, and that comparably situated employees are treated consistently.

8. The exception for separation pay has been expanded by defining termination for good reason as an involuntary separation, certain payments for which are not subject to section 409A

Rule: Payments on account of involuntary separation from service which do not exceed 2 times the lesser of an individual's annualized compensation or the maximum amount that can be taken into account as compensation for qualified plan benefits (\$225,000 for 2007) which are paid within 2 years of an individual's termination of employment are excepted from the rules of section 409A. The final regulations provide that termination under a good reason provision can be an involuntary separation from service if the good reason clause is not intended to avoid section 409A; involves (1) a material diminution in (i) base compensation, (ii) authority, duties, or responsibilities, (iii) authority, duties, or responsibilities of the supervisor to whom the employee reports, or (iv) budget; (2) a material change in geographic location; or (3) a material breach of the employment agreement; and the employee has provided notice to the employer of the good reason condition within 90 days, and the employer has 30 days to remedy.

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Effect: Employers will be able to structure good reason payments to enable specified employees separating from service for good reason to receive payments of up to \$450,000 amounts immediately upon separation from service, without any 6 month delay, if those payments are available only on an involuntary separation from service. Combined with the short-term deferral rules and the definition of payment, the regulations provide more flexibility to help employers manage traditional “severance” for specified employees.

9. Plan aggregation rules are changed to provide additional categories

Rule: Section 409A requires that payments from all similar plans be aggregated. The final regulations revise the aggregation categories to include elective account balance plans, nonelective account balance plans, non account balance plans, separation pay plans, split-dollar arrangements, in-kind benefit and reimbursement plans, stock rights subject to section 409A, foreign plans and amounts deferred under any other plan. In addition, the bifurcation rules of 31.3121(v)(2)-1(c)(1)(iii)(B) must be applied.

Effect: The increase in aggregation groups will limit the additional section 409A tax to lesser amounts of compensation in the event payments do not conform to the required rules.

10. Employers are provided with specific rules for payments both during the transition to the final rules and under the final regulations

Rule: Final regulations are effective January 1, 2008 and until December 31, 2007, the existing standard applies such that there can continue to be good faith compliance with the statute, Notice 2005-1, and the proposed or final regulations. Plans do need to continue to comply with Notice 2006-79 such that amendments and documentation should occur by December 31, 2007 and there can be no change in payments such that amounts are moved “in or out” of 2007. Stock rights granted before prior to publication of final regulations can comply with Notice 2005-1 or the proposed regulations for their remaining term and the good faith attempt standard of Notice 2006-4 continues to apply for purposes of determining whether a discounted option exists. Initial deferral elections and elections with respect to performance-based compensation continue to be effective and in compliance if they are in compliance with statute or guidance.

Effect: While documents do need to be conformed by the end of this year for periods on and after January 1, 2008 amendments are NOT required to retroactively bring the plan into compliance or document all operational compliance. However, taxpayers must be able to substantiate compliance with 409A during transition and thus should maintain memos to file, elections, agreements and other document to satisfy the requirement. While discount options can continue to apply the good faith standard to determine if the option is

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discounted, those that are discounted need to be reformed prior to the end of transition to comply with the rules. Timing and form of payment pursuant to previously made elections does need to come into compliance, even if agreed upon during the transition period. Payments on account of a separation from service payments that are currently in pay status, can continue or be revised and those not in pay status for separated employees should commence by the end of 2007. A good faith position with respect to application of 6-month delay will be respected.