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CLIENT ALERT

YEAR-END DOCUMENTATION DEADLINE FOR SEVERANCE AND OTHER NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS SUBJECT TO SECTION 409A OF THE INTERNAL REVENUE CODE

INTRODUCTION

In April 2007, the Internal Revenue Service issued final regulations under Section 409A of the Internal Revenue Code of 1986, as amended (the "Code Section 409A"). These regulations (the "Final 409A Regulations") are currently scheduled to become fully effective on January 1, 2009.

Among other things, the lengthy and complicated Final 409A Regulations require that severance and other nonqualified deferred compensation arrangements ("409A Compensation Arrangements") be in proper written form on or before December 31, 2008. Accordingly, an employer should act quickly to ensure that: (i) a complete inventory of all 409A Compensation Arrangements has been completed; and (ii) any amendments necessary to bring 409A Compensation Arrangements into compliance will be adopted before the year-end deadline. Failure to comply with the documentation requirements of the Final 409A Regulations may subject participants in the arrangement to immediate income taxation and a 20% penalty tax (plus interest) on all deferred amounts, whether or not currently distributable. An employer also may be subject to penalties and interest for failure to properly report income and withhold taxes in connection with the establishment and operation of a noncompliant Section 409A Compensation Arrangement.

BACKGROUND

Code Section 409A was enacted as part of the American Jobs Creation Act of 2004 in response to Congress' determination that executives had gained too much control over their nonqualified deferred compensation arrangements. Under Code Section 409A, nonqualified deferred compensation arrangements generally include bonus plans, long-term incentives, supplemental executive retirement arrangements ("SERPS"), equity compensation, elective

deferrals, employment agreements, stock options, stock appreciation rights and severance arrangements.

Specifically excluded from coverage under Code Section 409A, however, are “qualified” deferred compensation plans (e.g., employer sponsored retirement plans such as 401(k) plans and defined benefit plans), and certain fringe benefit arrangements (such as *bona fide* sick leave, vacation leave, death benefit plans, and medical expense reimbursement arrangements). Also excluded from coverage under Code Section 409A are “short term” deferral arrangements where payments must be distributed within 2 ½ months after the end of the taxable year in which they are fully earned and vested. This means that lump sum severance payments made upon termination from employment could be exempt from regulation under Code Section 409A if the severance arrangement provides for payment no later than 2 1/2 months after the end of the taxable year in which such payment is fully earned and vested, and such amounts are actually paid within that timeframe. Many bonus arrangements also may be able to take advantage of this exception.

Operational compliance with Code Section 409A has been required since January 1, 2005, and vested amounts deferred under a nonqualified deferred compensation arrangement before that date generally are exempt from the new requirements. In general, compensation is treated as deferred when there is a legally binding right to receive compensation that is payable in a later year. A legally binding right generally can exist for this purpose even if payment of the compensation is subject to contingencies, such as continued service or termination of service.

DOCUMENT REQUIREMENTS

General Requirements for Deferral Elections and Payments

On or before December 31, 2008, 409A Compensation Arrangements must meet certain “documentary compliance” requirements, including the requirement that each arrangement be in writing and include certain terms for the timing of deferral elections and payment of deferred amounts. As a general rule, the Final 409A Regulations provide that to satisfy the writing requirement, the document or documents constituting the arrangement must specify, at the time an amount is deferred, the amount to which the recipient has a right to be paid (or, in the case of an amount determinable under an objective, nondiscretionary formula, the terms of such formula), and the payment schedule or payment triggering events that will result in a payment of that amount.

It is particularly important that payment triggering events be specified in writing because amounts deferred under a 409A Compensation Arrangement cannot be accelerated on a discretionary basis, either by the payer or recipient. If a fixed time for payment is not identified at the time an amount is deferred, that amount generally can be paid only upon the happening of certain permissible, specified events, such as:

- in accordance with a fixed payment schedule;
- the death or disability of the recipient;
- a change in the ownership or effective control of the payer; or
- unforeseeable emergency.

Under the Final 409A Regulations, payment also is permitted upon separation from service, although key employees of public companies generally must wait six months from the separation date to begin receiving payment or benefits, as described more fully below. In general, the employment termination date will be deemed the separation from service date even if the employee and employer have entered into an agreement requiring the employee to continue to perform minimal services or be available to perform certain services after the termination date.

“Savings Clause” Ineffective to Avoid Penalties for Document Failures

The Final 409A Regulations provide that a general provision that purports to nullify noncompliant terms, or to supply required specific terms, will be disregarded in determining whether a written 409A Compensation Arrangement satisfies the documentation requirements of Code Section 409A. Accordingly, if a Section 409A Compensation Arrangement contains terms that do not meet the requirements of Section 409A and the Final 409A Regulations, or fails to contain a term necessary to meet those requirements, the arrangement will be treated as noncompliant even if the written arrangement contains a general “savings clause.”

Consequently, payments deferred under a 409A Compensation Arrangement that is missing required provisions or contains terms not consistent Code Section 409A requirements can be subject to current income taxation and penalties notwithstanding that those amounts are not immediately distributable. Accordingly, employers should carefully review the provisions of their Section 409A Compensation Arrangements and consult with an advisor before the year-end deadline to avoid adverse tax consequences.

Delayed Distribution Rule for Key Employees of Public Companies

Code Section 409A provides that payments to “key employees” of a public company upon separation from service must be delayed for at least six months following the employee’s termination date. A key employee is defined for this purpose as an officer earning more than \$135,000 per year, a 5% owner, or a 1% owner with compensation greater than \$150,000. These compensation dollar amounts are subject to future adjustment.

The six-month delayed distribution rule for key employees must be included as a written term for 409A Compensation Arrangements maintained by a public company. If an exception applies to a particular situation, however, key employees need not delay receipt of their severance pay and benefits until six months after they separate from service. For example, if a separation payment to a key employee of a public company qualifies as a short-term deferral because it is required to be paid under the written severance arrangement – and is actually paid –

within 2 ½ months following the end of the taxable year in which the payment is fully earned and vested, the six-month delay rule will not apply.

OTHER EXCEPTIONS FOR CERTAIN SEPARATION PAY ARRANGEMENTS

The Final 409A Regulations contain exceptions for various types of separation pay arrangements, including: (i) *bona fide* collectively bargained separation pay arrangements; (ii) involuntary separation payments or window program payments meeting specified time and amount limitations; (iii) foreign separation pay plans; (iv) expense reimbursement arrangements or in-kind benefits available for a limited period of time following a separation from service; and (v) *bona fide* legal settlement agreements. In all instances these exceptions apply only to the extent that the right to payment is conditioned upon a separation from service (including a separation from service due to death or disability) and not to compensation the individual could receive without separating from service (such as an amount also payable upon a change in control, as a result of an unforeseeable emergency or on a date certain).

Separation Pay Pursuant to a *Bona Fide* Collectively Bargained Agreement

The Final 409A Regulations provide that a nonqualified deferred compensation arrangement maintained pursuant to one or more collective bargaining agreements in effect on October 3, 2004, is not required to comply with the provisions of Code Section 409A on or before the earlier of the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any agreement after October 3, 2004) or December 31, 2009. In addition, special relief is granted to collectively bargained agreements subject to Code Section 409A to the extent an agreement provides for payment upon separation from service or pursuant to a window program. Only the portion of the separation pay arrangement attributable to employees covered by a *bona fide* collective bargaining agreement is eligible for this exception.

In general, a separation pay arrangement will qualify for this exception if it:

- is part of an agreement that the Secretary of Labor determines to be a collective bargaining agreement;
- was the subject of arms' length negotiations between employee representatives and employers; and
- the circumstances surrounding the arrangement evidence good faith bargaining between adverse parties.

Involuntary Separation Payments or Participation in a Window Program

In general, this exception applies to a separation pay arrangement (other than a collectively bargained separation arrangement) to the extent that payment is available solely due to an involuntary separation from service or pursuant to participation in a window program. To

qualify for this exception, the amount and time of payment must be limited under the terms of the arrangement, as follows:

- separation pay may not exceed the lesser of: (i) two times the departing employees' annual compensation for the prior calendar year, or if less, (ii) two times the qualified retirement plan maximum compensation limit under Internal Revenue Code §401(a)(17) for the year in which the service provider has a separation from service; and
- the separation amount must be fully paid to the recipient no later than December 31 of the second calendar year following the calendar year in which the separation date occurs.

Involuntary Termination

Whether an individual's separation from service was voluntary or involuntary for purposes of Code Section 409A is to be determined based on the facts and circumstances of each situation. Being fired by the employer, however, usually will be treated as an involuntary separation. In addition and as discussed more fully below, under certain circumstances a voluntary separation from service for "good reason" will be treated as an involuntary separation. The Final 409A Regulations also establish a rebuttable presumption that the employer and employee's characterization of the separation from service as voluntary or involuntary is proper.

"Good Reason" Termination Treated as Involuntary Termination

The Final 409A Regulations generally provide that a termination initiated by an employee for "good reason" will be treated as an involuntary separation. The term "good reason" generally means employer action that results in a material, negative change to the employee's relationship with the employer. Under a "safe harbor" definition, good-reason terminations include the following events: (i) a material diminution in the employee's base compensation, authority, duties or responsibilities or in the budget under the employee's control; (ii) a material diminution in the authority, duties or responsibilities of the supervisor to whom the employee is required to report; (iii) a material change in geographic location of the employee's work; or (iv) material breach by the employer of the terms of an employment agreement. In addition, separation from service must occur within two years of the triggering event, and the amount, time and form of payment must be substantially identical to the amount, time and form of payment upon a true involuntary termination. The employee also is required to give the employer notice of the existence of the good reason condition within 90 days after the condition arises, and a reasonable opportunity, at least 30 days, to cure the condition.

Participation in a Window Program

In general, a window program is defined as a program established by the employer, for a period of no more than one year, to provide for separation pay to certain employees who separate from service during that period. If an employer establishes a pattern of repeatedly providing similar pay under similar circumstances over a consecutive period of time, however, it will not qualify as a window program and any payments made pursuant to such an arrangement will remain subject to the special rules of Code Section 409A. The determination of whether a pattern exists for this purpose is to be made based on the facts and circumstances involved, and no one factor is determinative. Relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the separation pay relates to the event or condition, and whether the event or condition is temporary or a permanent aspect of the employer's business.

Foreign Separation Pay Arrangements

A separation pay arrangement generally is exempt from Code Section 409A regulation to the extent that it provides for payments of "foreign earned income" that are required under the applicable law of a foreign jurisdiction.

Expense Reimbursement and Fringe Benefit Arrangements

Reimbursement of certain deductible business expenses not excludible from gross income, and the receipt of certain fringe benefits such as outplacement services generally will not be treated as deferred compensation subject to Code Section 409A if certain conditions are met. For example, to qualify for this exception, separation expenses generally must be incurred, or benefits provided, no later than December 31 of the second calendar year following the calendar year in which the termination occurs, and actual reimbursement must be made by the end of the third calendar year following the year of separation. Reimbursement amounts and fringe benefits that do not meet the requirements specified in the Final 409A Regulations must comply with the requirements of Code Section 409A to avoid penalties.

Bona Fide Legal Settlement Arrangements

Also generally excepted from Code Section 409A coverage are settlement arrangements that provide for payments to resolve *bona fide* legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, (including claims under applicable Federal, state, local, or foreign laws), regardless of whether these payments are treated as compensation or wages for Federal tax purposes. Payments covered by this exception include the reimbursement or direct payment of reasonable attorney fees or other reasonable expenses incurred by the employee related to such *bona fide* legal claims.

It is important to note that the payment of a pre-existing deferred compensation amount must comply with Code Section 409A requirements even if a payment is made in connection with the settlement of a *bona fide* legal claim. For example, any settlement arrangement that has the effect of modifying an existing deferred compensation obligation will not be exempt from Code Section 409A, even if a *bona fide* employment claim is settled at the same time.

The Final 409A Regulations also generally provide that the IRS will consider the facts and circumstances surrounding a settlement to determine whether the waiver of claims is a settlement of a *bona fide* claim.

Penalties for Noncompliance

Substantial penalties are imposed under Code Section 409A for compliance failures, and noncompliance with respect to one payment or benefit may taint other payments and benefits.

In general, a person entitled to receive payment pursuant to a noncompliant 409A Compensation Arrangement will be subject to the following penalties:

- immediate income taxation on all deferred amounts, whether or not currently distributable;
- imposition of an additional tax equal to 20% of the compensation required to be included in gross income; and
- interest assessed at the Federal underpayment rate, plus 1%, for the period beginning on the deferral date

Taxes or penalty amounts paid by the employer on behalf of the employee constitute additional income to the employee for which taxes will be due. An employer also may be subject to penalties and interest for failure to properly report income and withhold taxes in connection with the establishment and operation of a noncompliant Section 409A Compensation Arrangement.

Accordingly, employers should carefully review each 409A Compensation Arrangement and consult with an advisor before the year-end deadline to avoid significant adverse tax consequences.

Please do not hesitate to contact us with any questions regarding 409A compliance.

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