

- **Stock Options**
- **Employment, Change in Control and Severance Agreements**
- **Traditional Deferral Arrangements and SERPs**

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Final 409A Deadline Looming

All Deferred Compensation Arrangements Must be in Full Compliance by December 31, 2008

Section 409A is an extremely broad law that covers many arrangements not generally considered deferred compensation, such as stock options, bonus plans, and severance and change in control agreements. In general, 409A governs any arrangement where an employee or consultant has a vested right to compensation in one year that will be paid in a later year, unless the arrangement fits into one of the exemptions to 409A. Arrangements subject to 409A must comply with strict rules as to the time and form of payment, and it is very difficult to make changes to an arrangement once it is in place. Any deferred compensation arrangement that does not comply with 409A will subject the employee or consultant to income tax liability at the time that the right to payment vests (even if there is no right to receive payment at that time), together with a 20% penalty tax on the deferred amount.

Under transition rules that have been in effect since 2005, it has been sufficient to be in “good faith” compliance with 409A, and certain changes to deferral arrangements have been permitted. *That transition period will end as of December 31, 2008, and no further postponements of this deadline are expected. Beginning on January 1, 2009, all deferral arrangements must be in full compliance with 409A.*

All employers, *whether public or private companies*, should take the following action prior to December 31, 2008:

- Review all arrangements for the payment of deferred compensation to confirm full compliance - both in form and operation - with Section 409A.
- Make any desired changes to the time or form of payment under existing arrangements.
- *For public companies only*, ensure that any arrangement for payment of deferred compensation to a “key employee” upon separation from service provides for a six month delay in such payment, as discussed below.

The following checklist provides some guidance for regularly-occurring 409A issues. Given the broad coverage of 409A and the complexity of the 409A guidance, however, a complete discussion is beyond the scope of this overview. We strongly recommend that all companies consult their legal advisers as soon as possible with respect to 409A compliance.

I. STOCK OPTIONS

- To be exempt from 409A, stock options
 - must be issued with an exercise price at least equal to fair market value of the stock as of the date of option grant,
 - must be exercisable for “service recipient stock” (generally, common stock of the employer or a parent or subsidiary of the employer), and
 - cannot have any other feature for deferral of income.

Any “discount options” (options issued with an exercise price less than fair market value) must be brought into compliance with 409A by 12/31/08.

- Incentive Stock Options (“ISOs”) are expressly exempt from 409A. If the option ceases to qualify as an ISO, however, it will violate 409A if it does not meet the above requirements.
- For private companies, fair market value may be determined by any “reasonable method, reasonably applied”; however, obtaining an independent valuation (or for a start-up company, a valuation from someone with business expertise who may be affiliated with the company) provides a safe harbor pursuant to which the valuation will be presumed to be correct.
- Options that are not exempt from 409A may be designed to comply with 409A by specifying the time periods when such options may be exercised.

II. EMPLOYMENT, CHANGE IN CONTROL AND SEVERANCE AGREEMENTS

A. Severance (or Separation Pay) Arrangements

- Severance (referred to as Separation Pay) that is payable only upon involuntary termination of employment is exempt from 409A if :
 - it is paid within the “short-term deferral period” (that is, by the later of (i) 2 1/2 months after the end of the employee or consultant’s tax year or (ii) 2 1/2 months after the end of the employer’s tax year); or
 - it meets the “two times, two year” rule (that is, the Separation Pay (1) is no more than twice the lesser of (i) the employee or consultant’s base compensation for the preceding taxable year, or (ii) the 401(a)(17) limit on compensation, which is \$230,000 for 2008, and (2) is paid by the end of the second year following termination).
- Involuntary termination includes termination for “Good Reason” only if the good reason definition either meets the 409A safe harbor “Good Reason” definition or requires a material adverse change in the employment relationship.
- For both private and public companies, any severance that is not exempt from 409A:
 - must be payable *only* upon specified 409A permissible events (Separation from Service, Disability or death, or Change in Control of the company) or a upon a date certain; and
 - cannot provide for any change in timing or form or payment, except as permitted by 409A.
- For public companies, any arrangement for the payment of severance (that is not exempt from 409A) to a “key employee” upon separation from service must provide for a six-month delay in payment following separation from service. *This provision must be written into the agreement prior to 12/31/08.*

NOTE: A “key employee” includes an officer with annual compensation in excess of \$150,000 (for 2008, subject to future indexing), a 5% owner, or a 1% owner with annual compensation in excess of \$150,000

B. Bonus Payments

- Bonus payments will be subject to 409A if payment is made after the end of the year for which the bonus is earned, but such payment will be exempt if paid during the short-term deferral period described above.
- If the bonus cannot be payable within the short-term deferral rule, the agreement must provide a fixed time for payment.

III. TRADITIONAL DEFERRAL ARRANGEMENTS AND SERPS

A. Traditional Salary or Bonus Deferral Arrangements

- Elections to defer compensation must be made in writing by no later than the end of the year prior to the year in which the compensation is earned (or within 30 days of the date a new deferral arrangement is put into place). The election must specify the time and form of payment.
- For public companies, any payment of deferred compensation to a “key employee” upon separation from service must provide for a six-month delay in payment.
- Once an election has been made, the time of payment *cannot* be accelerated. Changes to the form of payment, or elections to further defer the time of payment, (i) must be made at least one year prior to the originally scheduled payment date, and (ii) must defer the payment for at least 5 years after the originally scheduled payment date.
All employees making deferral elections should understand these rules.
- Between now and December 31, 2008, however, changes can be made to the time and form of payment (without complying with the 409A rules described above), provided that such change is not made with respect to a payment that would otherwise be made in 2008 and the change does not result in a payment being made in 2008. *Employees should review any existing deferral elections as to time and form of payment, and make any desired changes prior to 12/31/08.*

B. Supplemental Executive Retirement Plans (SERPs)

- Supplemental executive retirement plans (SERPs) are deemed to be deferred compensation for purposes of Section 409A, and must comply with the rules discussed above for elective deferrals. *For public companies, any SERP providing for payment to a “key employee” upon separation from service must include the mandatory six-month delay provision.*
- If the SERP provides a choice as to time and/or form of payment, the election must be made within 30 days of the date the SERP is put into place.
- Once an election has been made as to time and form of payment, the time of payment cannot be accelerated. Any change to the form of payment, or election to further defer payment, must be made at least one year prior to, and defer payment for at least 5 years after, the originally scheduled payment date.
- As discussed above, the 409A transition rules allow certain changes to be made prior to December 31, 2008. *Any executive who has elected installment or annuity payments should be advised that after December 31, 2008, it will be impossible to change to a lump sum payment without delaying payment five years after the originally scheduled payment date.*

FINAL NOTE:

Finally, for any arrangement that is potentially subject to 409A, consider adding a savings clause to the agreement providing that the agreement will be interpreted in accordance with 409A. Such a savings clause will not, in and of itself, make an arrangement 409A compliant, but it may help if there is ambiguity as to the terms of the arrangement.

The above provides only a brief overview of 409A compliance issues. Please contact [Terry Martland](mailto:tmartland@foleyhoag.com) at Foley Hoag LLP at tmartland@foleyhoag.com with any questions you may have on the above.



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