

News from our Compensation & Benefits Group

Halloween Treat: IRS Issues Real Transition Relief Under Section 409A

On October 22, 2007, the IRS issued Notice 2007-86 (see www.treas.gov/press/releases/hp631.htm), which generally provides taxpayers with an additional year in which to take advantage of certain transition rules to bring nonqualified deferred compensation plans and arrangements into compliance with Section 409A of the Internal Revenue Code and the final regulations issued thereunder.

Background

Section 409A covers a wide range of non-qualified deferred compensation plans and arrangements (including “traditional” cash deferred compensation plans and agreements governing stock options, bonuses and severance) and imposes a number of strict requirements on such plans and arrangements for participants to avoid premature taxation, an additional 20% federal income tax, and an interest-charge tax. Section 409A and its impact on various forms of nonqualified deferred compensation plans and arrangements are discussed in our prior *Cooley Alerts* (see www.cooley.com/news/alerts.aspx?practiceid=37398720).

Effective since January 1, 2005, Section 409A requires affected plans and arrangements to be operated in reasonable, good faith compliance with the provisions of Section 409A. Starting with Notice 2005-1, the IRS has issued a series of guidance that (1) established transition rules explaining how employers and participants could operate nonqualified deferred compensation arrangements in good faith compliance and (2) repeatedly extended the date by when affected plans and arrangements needed to

comply with certain documentation requirements. These transition rules included provisions for “curing” discounted stock options and changing existing severance rights.

On April 10, 2007, the Department of Treasury and the IRS issued final regulations under Section 409A (see final regulations at www.treasury.gov/press/releases/reports/td9321.pdf), which provided guidance regarding the requirements for deferral elections and payment timing under Section 409A. Under the final Section 409A regulations, nonqualified deferred compensation plans and arrangements were required to comply with the final regulations no later than January 1, 2008. On September 10, 2007, the IRS issued Notice 2007-78, which (1) confirmed that the transition rules for compliance would no longer apply after December 31, 2007 and (2) extended until December 31, 2008 the date by when affected plans and arrangements needed to comply with certain documentation requirements of Section 409A.

Notice 2007-86

What does Notice 2007-86 do? Notice 2007-86 generally delays until January 1, 2009 the effective date of the final Section 409A regulations. This delay means that employers and participants have an additional year to take advantage of the transition rules and still be deemed to be operating such plans and arrangements in good faith compliance with the provisions of Section 409A.

Notice 2007-86 also confirms that Treasury and the IRS anticipate issuing guidance, in

the near future, that will establish a limited voluntary compliance program permitting corrections of certain unintentional operational violations of Section 409A.

In a *Cooley Alert* issued just last month (see www.cooley.com/news/alerts.aspx?id=40778820), you said that the IRS had

KEY ATTORNEY CONTACTS

Mark Bradford.....	650/843-5158 mbradford@cooley.com
Wendy Davis.....	650/843-5157 wdavis@cooley.com
Soo Kim.....	212/479-6760 skim@cooley.com
Michelle Lara.....	858/550-6011 mlara@cooley.com
Dan Meehan.....	720/566-4061 dmeehan@cooley.com
Buff Miller.....	650/843-5351 bmillier@cooley.com
Amy Muecke.....	858/550-6058 amuecke@cooley.com
Tom Reicher.....	415/693-2381 treicher@cooley.com
David Walsh.....	703/456-8021 dwalsh@cooley.com
Thomas Welk.....	858/550-6016 twelk@cooley.com

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not extended the period in which we could fix eligible outstanding discounted stock rights, amend executive employment agreements and make certain changes to deferred compensation payment elections. How does Notice 2007-86 change our ability to take these actions?

Under Notice 2007-86, you now have until December 31, 2008 to:

- ▶ fix eligible outstanding discounted stock rights (*i.e.*, discounted stock options and stock appreciation rights held by certain employees);
- ▶ amend employment agreements to document the way in which the six-month delay of severance payments to “specified employees” will be implemented or to clarify the terms of an existing definition of “good reason” as a trigger for severance payments;
- ▶ designate each payment in a series of installment payments as a separate payment;
- ▶ establish a compliant time and form of payment in writing under a nonqualified deferred compensation plan;
- ▶ remove a non-compliant distribution event (such as a “haircut” provision) from a plan, provided that the plan must be operated in compliance with 409A (*e.g.*, disregarding the “haircut” provision) prior to the time you amend the plan;
- ▶ permit participants to add, remove or modify a compliant time and/or form of payment under an existing plan, provided that if the change is made in 2007, the change may apply only to amounts that would not otherwise be payable in 2007 and may not cause an amount to be paid in 2007 that would not otherwise be payable in 2007, and if the change is made in 2008, the change may apply only to amounts that would not otherwise be payable in 2008 and may not cause an amount to be paid in 2008 that would not otherwise be payable in 2008;

- ▶ change an existing payment provision in the plan or an existing payment election by a participant that provides that the time and form of payment under the nonqualified plan is the same as the payment election made by the participant under a qualified plan; and
- ▶ amend a nonqualified deferred compensation plan to come into documentary compliance with Section 409A, as long as the amendments to the plan are effective not later than January 1, 2009 and reflect the plan’s operation in compliance with Section 409A prior to such time.

However, even though Notice 2007-86 extends the period in which you can amend your nonqualified deferred compensation plans to comply with Section 409A, you are still required (and have been since January 1, 2005) to operate your nonqualified deferred compensation plans and arrangements in reasonable, good faith compliance with Section 409A.

Does Notice 2007-86 allow us to rely on the proposed regulations prior to January 1, 2009 instead of the final regulations?

Only on a limited basis. As noted above, you are required to operate nonqualified deferred compensation plans in reasonable, good faith compliance with Section 409A. Prior to 2008, such compliance can be shown by complying with the proposed regulations, the final regulations or Notice 2005-1. Under Notice 2007-86, reliance on the proposed regulations will not be considered compliance with Section 409A after December 31, 2007, except with respect to (1) the application of Section 409A to partners and partnerships and (2) the permitted “cures” for discounted stock rights held by certain non-officer employees. In each case, reliance on the proposed regulations is allowed only until further guidance on these topics is issued.

Does Notice 2007-86 change the ways in which we can fix outstanding discounted stock rights?

No. Although Notice 2007-86

extended until December 31, 2008 the period in which companies can fix discounted stock options, it did not change the available methods for fixing such options. The two most common methods are:

- ▶ substituting a non-discounted stock option for the discounted stock option (in effect, increasing the exercise price for the option to the fair market value of the underlying stock as of the appropriate grant date); and
- ▶ permitting the optionees to elect fixed exercise terms under the options (*e.g.*, exercise is permitted on the earliest of a separation from service, a change of control, or a specified calendar year) consistent with Section 409A.¹

Does Notice 2007-86 extend the period in which we can fix discounted stock options held by our executive officers?

No. Notice 2007-86 confirms the guidance provided in Notice 2006-79 that discounted stock options ceased to be curable after December 31, 2006 if:

- ▶ those options were granted with respect to the stock of a public company (at the time of grant);
- ▶ those options were granted to persons who were Section 16 officers of that public company (at the time of grant); and
- ▶ with respect to such grants, the company has reported or expects to report a financial expense due to the discounted stock right that was not timely reported on financial statements or reports for the applicable period when such financial expense should have been reported.

Does Notice 2007-86 explain how to calculate amounts that are subject to taxation under Section 409A or how to report on Form W-2 for 2007 amounts that are subject to Section 409A?

No. However, on October 23, 2007, the IRS issued Notice 2007-89 (see www.irs.gov/pub/irs-drop/n-07-89.pdf), which generally extends for 2007 the guidance provided for 2006 in

Notice 2006-100 on reporting and withholding taxes for amounts subject to Section 409A. We anticipate issuing a separate *Cooley Alert* in the near future discussing Notice 2007-89.

The IRS seems to keep changing its mind and issuing new guidance on Section 409A. Should we wait until next year to take any actions? The IRS has given employers and participants much needed additional time to review their non-qualified deferred compensation plans and arrangements and implement any necessary amendments. Some companies may wish to delay initiating or completing their Section 409A self-audit until 2008 given the prospect of additional guidance from the IRS on the voluntary compliance program as well as the usual increased demands on staff time arising at the end of each calendar year. However, there are a number of compelling reasons why employers and participants may wish to press forward with their Section 409A self-audits.

Avoiding unintentional operational violations. As noted above, even though Notice 2007-86 extends the period in which you can amend your plans to comply with Section 409A, you are still required to operate your deferred compensation plans in reasonable, good faith compliance with Section 409A. Ordinary course events, such as the hiring or termination of employees and executives, small delays in paying incentive bonuses, the exercise of discounted stock options, and even the start of the new calendar year, hold the potential for violations of Section 409A. You can minimize the risk of unintentionally failing to comply with Section 409A by identifying the plans and arrangements that are subject to Section 409A and determining any deficiencies in your documents or practices.

Maximizing the window to implement Section 409A amendments. Section 409A applies to a broad array of compensation arrangements, and the solutions necessary to fix non-compliant arrangements can

be very complicated and time-consuming. Give your human resources and legal staff sufficient time to complete the steps necessary to implement Section 409A cures by making the self-audit process a priority. If you have not yet started your audit, consider that you may need to:

- ▶ collect written consents to the proposed amendments and/or payment election forms from hundreds of employees, directors and independent contractors;
- ▶ determine corrected exercise prices for discounted stock options granted on multiple grant dates;
- ▶ conduct a tender offer to cure discounted stock options, which may require securing waivers from applicable securities laws requirements;
- ▶ commence and conclude the process of restating the company's financial statements for multiple years; and/or
- ▶ seek board and/or compensation committee approval of the proposed Section 409A amendments.

Minimizing delays in making payments or distributions. If you will need to amend discounted stock options, you should understand that, under Section 409A, any bonus paid to compensate employees for agreeing to increase their exercise price may not be paid in the same calendar year as the amendment to the option. Similarly, under Section 409A, if optionees are instead allowed to pick a year of exercise as the cure, they may not select the year in which they make that election. If you can complete your stock option cure program by December 31, 2007, optionees will benefit from the minimal delay between the amendment of their option and the start of a new calendar year – that is, they can be paid the bonus in January 2008 or select 2008 as the year of exercise. Remember that your cure program may require the use of a tender offer (even if you are a privately held company) and that the tender offer must remain open for at least 20 business

days. In order to complete your tender offer in 2007, you will need to launch it no later than December 3, 2007.

Maximizing flexibility in payment elections. Section 409A limits the ability of participants to make payment elections that “pull” payments from future years into the current year or “push” payments from the current year into future years. By allowing participants to change their payment elections before January 1, 2008, participants can elect to receive in 2008 payments currently scheduled to be received after 2008 or can elect to receive after 2008 payments currently scheduled to be received in 2008.

Minimizing complications in extraordinary transactions. Section 409A compliance is increasingly a focus of diligence and negotiation in corporate transactions such as initial public offerings and mergers and acquisitions. By getting started on your self-audit now, you can minimize distractions to your staff during these important events.

What is the first step to take if we have not yet commenced our Section 409A self-audit? To initiate your self-audit, you will need to first determine which of your compensatory plans, agreements and arrangements are subject to Section 409A. For a list of such plans, agreements and arrangements, please see our July 1, 2007 *Cooley Alert* (see www.cooley.com/news/alerts.aspx?id=40657220). In addition, the Compensation & Benefits Group at Cooley is prepared to work with you to identify and, where necessary, amend deferred compensation plans and arrangements.

Circular 230 disclosure

The following disclosure is provided in accordance with the Internal Revenue Service's Circular 230 (21 CFR Part 10). This *Alert* is not intended to constitute tax advice to any specific taxpayer or for any specific situation. Any tax advice contained in this *Alert* is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used

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If you have questions about this *Alert*, please contact one of the attorneys listed above. ■

Notes

¹ Note that the fixed exercise date may not occur in the same year as the election and may not be used for any discounted option that has been exercised in part after 2005.