The Treasury Department and Internal Revenue Service (IRS) issued final Section 409A regulations on April 10, 2007. The final regulations are effective January 1, 2008, but taxpayers are allowed to rely on the final regulations even if they conflict with prior interim guidance.

On April 16, 2007, we issued a Client Alert covering the main highlights of the final Section 409A regulations. The present Client Alert specifically focuses on the treatment of separation pay arrangements and change of control benefits under the final regulations.

We strongly encourage all of our clients, after reading this alert, to inventory and review all arrangements that provide for separation pay and to assess Section 409A applicability and compliance.

Reminder of Section 409A Tax Impact

1. What are the tax implications if a separation pay arrangement is subject to Section 409A, but fails to comply?

   The penalties for violating Section 409A of the Internal Revenue Code include immediate income tax inclusion, an additional 20 percent federal penalty tax, and interest charges (and in California, an additional 20 percent state tax). For example, employees in California will be subject to adverse tax consequences under state law provisions and have total potential taxation at rates above 84 percent.

   Employers will have wage reporting and withholding obligations if compensation is subject to Section 409A. IRS Notice 2006-100 provides guidance with respect to wage reporting and withholding obligations under Section 409A, and that guidance may continue to be relied upon until further IRS guidance is issued.

Reminder of Transition Period to Fix 409A Problems

2. Must existing separation pay arrangements be amended to comply with Section 409A?

   Yes. Separation pay arrangements adopted before December 31, 2007, will be able to operate in good-faith compliance with Section 409A so long as they are amended to comply with the final regulations by December 31, 2007. If an arrangement is subject to Section 409A and does not comply by January 1, 2008, then the employer and the affected employee will be subject to the obligations and tax penalties discussed in question 1.

The Basics: Defining Separation Pay

3. What is “separation pay”?

   “Separation pay” is compensation that an employee has a right to receive only after a separation from service (including a separation from service due to death or disability). Separation pay does not include compensation that an employee could receive without separating from service (such as an amount payable upon a change of control without a termination of employment, an unforeseeable emergency, or a payment scheduled to be paid on a date that is certain and fixed).

   **Continued on page 2...**

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1 For the remainder of this alert, the term “employee” should be read to include a non-employee service provider unless we clearly indicate otherwise.
For example: The right to a gross-up payment for taxes owed by an employee is separation pay if separation from service is required to obtain the payment. On the other hand, the right to a gross-up payment is not separation pay if payable while in service.

4. **What kind of payments and benefits are “separation payments”?**

Almost any kind of compensation or benefit that is given following separation from service may be impacted by Section 409A, such as severance pay, taxable medical reimbursements, and taxable fringe benefits. These items are highlighted in the final regulations.

**The Basics: Defining a Separation from Service**

5. **What is “separation from service” for purposes of Section 409A?**

A “separation from service” occurs when an employee dies, retires, or has a termination of employment. Whether an employee has a termination of employment is based on the particular facts and circumstances. When an employee quits or is let go, and will have no future contact with the company, that is a clear termination of employment. However, there are many situations, such as those in which an employee transitions to a consulting relationship or a part-time arrangement, where it is not so clear cut.

For example: If an employee is moving to a part-time schedule or a consulting relationship, the company would need to determine whether the employee has had a “separation from service.”

To determine that an employee has a separation of service, the final regulations require that the facts and circumstances indicate that there is no “reasonable anticipation” by the company or the employee that any services would be performed after a specified date, or that the level of bona fide services after that date would permanently decrease to no more than 20 percent of the average level of the services that the employee performed over the prior 36 months (or the total period during which the employee provided services to the company, if shorter). If the employee's service level decreases below this 20 percent level, he or she is presumed to have separated from service. On the other hand, the employee will be presumed to not have separated from service if he or she continues to provide 50 percent or more of the average level of services he or she provided over the measuring period. Any amount of continued service between the 20 and 50 percent levels requires analysis of facts and circumstances.

6. **Is a reduced-hours schedule a separation from service?**

Under the final regulations, a separation from service does not automatically occur in a reduced-hours schedule situation (including situations in which an employee is put on a reduced-hours schedule to phase into retirement). However, the final regulations permit flexibility for employers to define separation from service as including a change to a reduced level. In order to take advantage of this flexibility, employers must explicitly elect the point at which the separation of service will be deemed to occur. This election must be made no later than when the time and form of payment of the separation payments are elected or specified. The elected reduced level must be set at a specific percentage of service that is greater than 20 percent but lower than 50 percent of the average level of services provided in the immediately preceding 36 months.

For example: A separation pay arrangement may specify that a separation from service will be deemed to occur at any time that the employer reasonably anticipates that the level of services the employee will perform will be permanently reduced to a level that is 40 percent of the prior 36 months of service.

7. **Who is the “employer” when discussing a separation from service?**

The final regulations prevent employers from playing games (to allow a distribution) by having an employee terminate employment with one company in order to work with another company in the same controlled group. They contain special rules defining an “employer” or “service recipient” to include controlled group members using a 50 percent ownership threshold or, if specified by the employer, a range between 20 and 80 percent, so long as any percentage below 50 percent is based on legitimate business criteria.

Continued on page 3...
8. **Is a bona fide leave of absence treated as a separation from service?**

A bona fide leave of absence (in which there is a reasonable expectation the employee will return to service with the employer) is not treated as a separation from service if it is less than six months. Even if the leave of absence is longer than six months, it still is not treated as a separation from service if the employee has a right to re-employment under an applicable law (e.g., the Family and Medical Leave Act or the Uniformed Services Employment and Reemployment Rights Act) or by the terms of a contract (e.g., an oral or written agreement that states that employment continues even if the employee is on a one-year sabbatical).

9. **Does a separation from service occur in an asset sale?**

Ordinarily, an asset sale (where employees are transferred in connection with such assets) is considered a separation from service by law for those employees, potentially entitling them to benefits (such as COBRA continuation coverage and 401(k) distributions) and compensation under certain circumstances. The final regulations allow the buyer and seller in a sale of substantial assets to apply the so-called “same desk” rule (so that the transaction is not deemed a separation from service) where an employee essentially is continuing in his or her same job, provided (1) the asset purchase transaction results from bona fide, arms-length negotiations, (2) all such employees are treated consistently, and (3) such treatment is specified by the closing date for the transaction. An employer, after meeting these requirements, could treat such a sale as not causing a separation from service for purposes of Section 409A.

10. **Is a disability leave considered a separation from employment?**

No. The employment relationship, in a disability-leave situation, is treated as continuing for a period of up to 29 months, unless it is terminated by the employer or the employee, regardless of whether the employee retains a contractual right to re-employment.

11. **Can a separation from service be delayed by maintaining a salary continuation or terminal leave program?**

No. The final regulations do not treat salary continuation and terminal leave programs (e.g., a leave of absence where the employee is not expected to return and is, for all intents and purposes, not going to provide service any longer) as delaying separation. The Treasury Department and the IRS have stated that they believe these types of actions are subject to manipulation and should not delay the time at which an employee is treated as having separated from service for purposes of Section 409A. In addition, terminal leave with no intent to return generally would not be treated as a bona fide leave.

**The Basics: When Does Section 409A Apply?**

12. **When does Section 409A apply to separation pay arrangements?**

The final regulations provide that a separation pay arrangement is subject to Section 409A only to the extent the arrangement provides for “deferred compensation.” Under the regulations, deferred compensation is an arrangement that provides the employee a legally binding right to compensation during one taxable year that, pursuant to the terms of the arrangement, is or may be payable to the employee in a later taxable year. However, there is a short-term deferral period and certain other exceptions under which compensation paid in the next taxable year will not be considered deferred compensation for purposes of Section 409A.

13. **When does the short-term deferral exception apply?**

Compensation is not considered deferred for purposes of Section 409A if (1) the plan or agreement under which the payment is made does not provide for a deferral, and (2) an employee actually or constructively receives the payment on or before the last day of the applicable two-and-a-half month period ending on the later of:

- the 15th day of the third month following the end of the employee’s first taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture (usually March 15 of the next calendar year), or
- the 15th day of the third month following the end of the employer’s first taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture (this is helpful in cases where an employer pays taxes on a fiscal year basis).

*Continued on page 4...*
Separation Pay Arrangements . . .

Continued from page 3.

This is one of the most commonly used exceptions under Section 409A.

For example: Susan is a senior vice president of a start-up technology company, which has a calendar-year tax year. Her annual salary is $275,000. Her severance agreement provides that she is entitled to $625,000 if she is terminated without cause, payable in a lump sum within 30 calendar days of her separation from service. Her severance benefit represents two times her annual salary plus $75,000, which is the amount of her most recent target bonus. Susan is terminated without cause in 2007. Because all separation payments will be paid before March 15 of the year following separation, those payments fall within the “short-term deferral” exception and are not deferred compensation for purposes of Section 409A.

Any compensation paid after this short-term deferral period pursuant to any separation arrangement is deferred compensation subject to Section 409A, unless it falls within another exception (discussed below). Unlike the other exceptions discussed below, if a series of payments is being made, that stream of payments is not split up under the short-term deferral rule such that the payments before the March 15 date are exempt while those paid after the March 15 date are not (unless the requirements for the exception described in question 16 below are satisfied). Therefore, if $1 from a stream of payments is paid after the March 15 date, the entire stream of payments is not covered by the short-term deferral exception and you must rely on the other exceptions below to avoid being subject to Section 409A. (The dates in this answer assume that the employee and employer are calendar-year taxpayers.)

Other Separation Pay Exceptions to Deferred Compensation

14. Are there other separation payments that are exempt from Section 409A, even if there might be a deferral of compensation?

Yes. The final regulations generally retain other exceptions (in addition to the short-term deferral rule described above) from the definition of deferred compensation for certain types of separation pay. The exceptions include:

• arrangements providing separation pay (up to limited amounts) due to an involuntary separation from service or participation in a window program (a window program is a program that offers benefits for a limited period to encourage people to separate from service, such as an “early retirement” program);

• bona fide collectively bargained arrangements;

• arrangements providing for non-taxable benefits, COBRA, or expense reimbursements (e.g., reasonable moving expenses and outplacement services) for a limited period of time following separation from service;

• arrangements providing in-kind benefits (e.g., a corporate car or aircraft, membership dues, or payment for financial or tax advice) for a limited period of time following separation from service; and

• incidental amounts that do not exceed the Internal Revenue Code Section 402(g) limit (the deferral limit applicable to 401(k) plans and other defined contribution retirement plans, which is $15,500 in 2007).

Some of these exceptions are described further below. We also have included some examples at the end of this alert to show how the exceptions work in practice and how they interact with each other.

15. Are we limited to only one exception for each payment or can we use several if more than one applies?

You may use more than one exception. One important clarification in the final regulations is that the exceptions may be used in combination (that is, they can be used on an additive basis).

For instance, an amount of severance up to the maximum amount available under the involuntary termination/window program exception (as described below), expense reimbursements for reasonable moving expenses and outplacement expenses, and payments that do not exceed the limit on elective deferrals under Internal Revenue Code Section 402(g) all may be excluded from coverage under Section 409A due to application of the various exceptions, even if they are part of the same severance package.

Continued on page 5...
16. What are the limitations on the exception for separation pay due to an involuntary separation from service or participation in a window program?

Separation pay that is paid solely due to an involuntary separation from service or participation in a window program is excepted from the rules of Section 409A, so long as such pay is:

- payable no later than the end of the second taxable year of the employee following the year of separation from service; and
- limited to an amount that is the lesser of (1) two times the employee’s “annual rate of compensation” for the taxable year before the taxable year in which the separation of service occurs, or (2) two times the compensation limit set for tax-qualified retirement plans in Internal Revenue Code Section 401(a)(17) (this limit is $225,000 in 2007) for the year the separation from service occurs.

17. What does the IRS mean by the term “annual rate of compensation”?  

Unfortunately, the term “annual rate of compensation” is largely undefined in the final regulations. IRS officials have informally stated that the annual rate of compensation should be determined by the facts and circumstances, but that such term should include annual salary and bonus amounts that are regular (and almost certain to be paid), but should not include extraordinary bonuses or income derived from the exercise of stock options. Clearly this leaves a number of issues open, but standards will emerge as a body of practice develops. One helpful piece of guidance is that the rate may be annualized for partial years of service.

18. What happens if we pay more than the dollar limits set forth in question 16 under the exception for an involuntary separation from service or participation in a window program?

One favorable change in the final regulations is that the involuntary separation exclusion will continue to apply to payments up to the limitation amount, even if the total amount of the payments due to an involuntary separation from service is above the limit, as long as the payments up to the limit are made within the required timeframe (no later than the end of the second taxable year following the employee’s taxable year in which the separation occurs).

No six-month delay will be required for these payments, as typically would be required for deferred compensation paid to a specified employee (see question 36 below), because the involuntary separation/window program exception provides that amounts up to the limit are not deferred compensation.

For example: The annual salary and annual bonus of Mary, an executive, total $275,000. Under her severance agreement she is entitled to $550,000, payable over a two-year period, if she is terminated without cause, which represents two times her annual salary and bonus. Mary is terminated without cause by the company in 2007. Because certain payments will be paid after March 15 of the year following separation, those payments do not fall within the “short-term deferral” exception. Once that exception is off the table, we look to see how much of the payments can be removed from the definition of “deferred compensation” under the involuntary separation exception. Under this exception, up to $450,000 can be excluded. As a result, only the excess $100,000 ($550,000 - $450,000 = $100,000) will be subject to Section 409A requirements. If Mary is a specified employee of a public company, the excess $100,000 cannot be paid until a date six months following her termination.

19. When is a separation from service “involuntary”?

The final regulations provide that a determination of whether a separation from service is “involuntary” is based on all the facts and circumstances. However, characterization as voluntary or involuntary in the employer’s documentation relating to the separation from service is presumed to be the correct characterization (although the IRS could rebut this presumption). For these reasons, it is important for employers to properly document any involuntary separation that results in separation payments. It is important that public statements and filings regarding the cause of the separation accurately describe the separation.

Continued on page 6...
20. **Is a termination for “good reason” considered voluntary or involuntary?**

It depends. The final regulations make substantial and favorable changes with respect to a “good reason” separation from service. They provide that where a right to a payment is contingent upon a voluntary separation from service for good reason, the right may be treated in the same way as an involuntary separation from service. This treatment can only occur when:

- the motivation for adding the good reason condition is not Section 409A tax avoidance; and
- the good reason condition consists of action(s) taken by the employer that result in a material negative change in the employee’s employment (e.g., material negative change in the duties that are required to be performed or compensation paid).

Additional factors that may be relevant in determining whether a bona fide good reason condition exists include: (1) whether payments made after a separation for good reason are the same amount and made at the same time and in the same form as payments available following an involuntary separation from service, and (2) whether the employee is required to give notice of the existence of the good reason condition and the employer has a reasonable opportunity to remedy the condition.

An amount payable on account of a good reason separation meeting the above requirements will be treated as payable on account of an involuntary separation from service. As a result, payments on a good reason separation will be eligible for the involuntary separation/window program exception if they meet the other requirements of that exception.

21. **Do the final regulations provide a safe harbor for good reason terminations?**

Yes. The final regulations provide a safe harbor under which a voluntary separation for good reason will be treated as an involuntary separation from service under Section 409A.

The conditions for safe harbor treatment include the following:

- The amount may be payable only if the employee separates from service within two years following the initial existence of the condition giving rise to good reason.
- The service provider must provide notice of the existence of the good reason condition within 90 days of its initial existence.
- The employer must be provided a period of at least 30 days to remedy the good reason condition.
- The amount, time, and form of payment following a separation for good reason must be substantially the same as the amount, time, and form of payment following an involuntary separation from service.

A good reason condition falling under the safe harbor must occur without the consent of the employee, and consist of a material reduction in:

- the employee’s base compensation;
- the employee’s authority, duties, or responsibilities;
- the authority, duties, or responsibilities of the supervisor to whom the employee is required to report, including a requirement to report to a corporate officer or employee instead of reporting directly to the board of directors (or similar group for a non-corporate entity);
- the budget over which the employee must perform the services; or
- any other action or inaction that constitutes a material breach of the terms of an applicable employment agreement.

Please note that employers are not required to follow the good reason safe harbor; it is merely an opportunity offered under the final Section 409A regulations for employers to have certainty with respect to good reason terminations.
22. Are non-taxable benefits provided following a separation from service deferred compensation?

No. The final regulations clarify that a right to a benefit that is excludible from income will not be treated as a deferral of compensation for purposes of Section 409A (except in the rare circumstance that the employee has received that right in exchange for an amount that would be includible in gross income, other than a cafeteria plan described in Internal Revenue Code Section 125).

**For example:** Benefits that are excludible from income include health coverage, which is excludible from gross income under Internal Revenue Code Section 105.

This exception covers benefits under almost all employer-sponsored health plans.

23. Do taxable medical-benefit reimbursements provided after a separation from service constitute deferred compensation?

To the extent a medical reimbursement benefit is taxable (this is somewhat unusual but, for instance, might occur if the reimbursement is discriminatory under Internal Revenue Code Section 105(h)), the final regulations provide that they may be provided over the applicable COBRA coverage period (generally 18, 29, or 36 months) and will not constitute deferred compensation even though a legally binding right to a taxable medical benefit in a future year exists. This exclusion is limited to the period during which the employee would be entitled to COBRA continuation coverage under a group health plan of the employer if the employee elected such coverage and paid the applicable premiums.

24. Are other reimbursement arrangements provided following a separation from service deferred compensation?

The final regulations provide specific exceptions for certain post-separation reimbursement arrangements, including reimbursement for certain items deductible to an employer, reasonable outplacement benefits, and reasonable moving expenses for a limited period of time, whether or not the separation from service is voluntary or involuntary. The final regulations also permit reimbursement of any part of a loss due to the sale of a primary residence up to the amount of the loss.

Eligible expenses must be incurred by the service provider no later than the end of the second year following the year in which the separation from service occurs. Although the expenses must be incurred within this period, they may be paid later. Reimbursements must be made no later than the third year following the separation from service. If the reimbursements are not incurred and paid within the applicable timeframes, the reimbursements are a deferral of compensation and will be subject to Section 409A (unless another exception can be found to remove them).

25. Do in-kind benefits provided after a separation from service constitute deferred compensation?

The final regulations provide a specific exception for in-kind benefits (such as continued use of a corporate car or aircraft, membership dues, or payment for financial or tax advice) provided upon a separation from service. Such taxable benefits will not constitute a deferral of compensation and thus will not be subject to Section 409A, so long as they are provided by the end of the second year following the separation from service.

26. Is there an exception for small incidental payments and benefits, so we do not have to worry about Section 409A with every aspect of a separation pay arrangement?

Yes. The final regulations clarify that a taxpayer may treat certain de minimis amounts under a separation pay arrangement as not subject to Section 409A so long as the payments in the aggregate do not exceed the applicable limit under Internal Revenue Code Section 402(g) for the year of separation (this is the deferral limit applicable to 401(k) plans and other defined contribution retirement plans and is $15,500 for 2007). This is intended to avoid the application of Section 409A to small, incidental benefits under a separation pay arrangement.

**Special Separation Pay Rules**

27. How are separation pay arrangements with consultants and independent contractors treated under Section 409A?

The final regulations provide that Section 409A generally does not apply to an amount deferred under an arrangement between a company and a consultant (or independent contractor) if, essentially, the consultant truly is independent from the company. Specifically, the deferred amount...
Separation Pay Arrangements . . .
Continued from page 7...

paid to a consultant will not be subject to Section 409A if, during the taxable year in which the consultant obtains a legally binding right to a deferred amount, (1) the consultant is actively engaged in the trade or business of providing services (other than as an employee or as a director of a corporation), and (2) provides “significant services” to two or more companies to which the consultant is not related and that are not related to one another.

The final regulations retain the safe harbor contained in the prior interim guidance. Under this safe harbor, a consultant is deemed to be providing “significant services” to two or more companies if the revenues generated from the services provided to any single company or to a group of related companies during the relevant taxable year do not exceed 70 percent of the total revenues generated by the consultant from consulting work.

The final regulations adopt an additional safe harbor that provides that a consultant who has actually met the 70 percent threshold in the three immediately prior years is deemed to meet the 70 percent threshold for the current year, but only if, at the time the amount is deferred, the consultant does not know or have reason to anticipate that he or she will fail to meet the threshold in the current year.

The final regulations still require that the safe harbor arrangement, and the practices under the arrangement: (1) be bona fide, (2) arise in the ordinary course of business, and (3) be substantially the same as the arrangements and practices (such as billing and collection practices) applicable to one or more unrelated employers to whom the consultant provides substantial services and that produce a majority of the total revenue that the consultant earns from the trade or business of providing such services during the year.

The final regulations further clarify that if at the time the legally binding right to the payment arose, the arrangement was not subject to Section 409A because the consultant was an independent contractor eligible for this exclusion, the amount deferred under the arrangement during that taxable year (and earnings credited to the deferred amount) will not become subject to Section 409A in a later year just because the consultant becomes an employee, independent contractor, or other type of service provider subject to the rules of Section 409A.

The Treasury Department and the IRS are continuing to study whether a company will be permitted to rely upon a consultant’s representation that the consultant meets the exclusion requirements, so that a company will know with certainty whether it is subject to the reporting requirements with respect to amounts deferred subject to Section 409A.

Please note that an employee cannot be re-classified as a consultant or independent contractor to avoid application of Section 409A, because an individual’s current status as a consultant will be ignored with respect to amounts he or she earned as an employee.

28. What if we sometimes pay employees separation pay, but it is paid at our discretion (and not under a plan or agreement)?

An employee does not have a legally binding right to compensation if that compensation may be reduced unilaterally or eliminated by the employer or service recipient (that is, the compensation is subject to a substantial risk of forfeiture). Oftentimes, employers will provide that a payment is in the employer’s sole discretion and no right exists until the payment amount is actually paid. If the entire amount is paid immediately, it automatically is within the short-term deferral period and is not deferred compensation. Joining a substantial risk of forfeiture with payment within the short-term deferral exception is a very common practice to avoid application of Section 409A.

However, a discretionary separation payment may be subject to Section 409A if payments can be deferred beyond the short-term deferral period after the employer has agreed to pay and no substantial risk of forfeiture exists.

29. If we have a separation pay arrangement that constitutes deferred compensation, can we cancel it and set up a new arrangement resulting in other payments?

No. The final regulations continue to provide that any amount that acts as a substitute or replacement for amounts deferred under a separate deferred compensation arrangement constitutes a payment of deferred compensation. The policy concern is that without this rule, a new payment actually would be a deferral or acceleration of a formerly non-vested payment right.

The presumption that a right to payment is not a new right, but instead is a right substituted for a non-vested right, may be rebutted by demonstrating that the employee’s right to payment after the separation from service would have existed regardless of the forfeiture or cancellation.

Continued on page 9...
Factors indicating that a right to payment would have existed, regardless of the forfeiture or cancellation of the right to a non-vested payment, include whether the amount to which the employee obtains a right is materially less than the present value of the forfeited non-vested amount. Another factor is that the payment consists of a type of payment customarily made to an employee who separates from service with the employer without forfeiting non-vested rights to deferred compensation (for instance, an employer’s customary payment of two weeks’ severance for each terminating employee).

30. Can we accelerate or delay the vesting of stock options in connection with a termination without causing a Section 409A problem?

Generally, yes. The final regulations provide that accelerating the vesting of a stock right that is not subject to Section 409A (generally, a stock right is not subject to Section 409A if it was not granted at a discount) is not the type of modification that would pull the right into the definition of deferred compensation. However, the acceleration or delay generally must occur within the original term of the stock right; otherwise, it is considered an extension of the right and may violate Section 409A (see question 31 below). If the stock right is subject to Section 409A (for instance, because the stock right was granted at a discount on the date of grant), such acceleration or delay may constitute an impermissible acceleration of a payment date or a subsequent deferral under the regulations.

Please see our prior Client Alert about stock rights under the final Section 409A regulations.

31. Can we give an employee a longer period of time after termination in which to exercise options?

Generally, yes. The final regulations substantially relaxed the rules regarding an employer’s ability to amend an outstanding option (or other stock right) to provide for an additional period after termination during which an employee may exercise the option (or other stock right). The final regulations permit:

- an extension of the post-termination exercise period if it is not extended beyond (1) the stock right’s original expiration date, or (2) the 10th anniversary of its original date of grant, whichever falls earlier;
- extension of the exercise period if the stock right is underwater (that is, when the exercise price is more than the fair market value of the underlying shares). Of course, any extension still will be limited to the timeframes allowed by the governing plan; and
- the suspension of the expiration of the stock right while the holder cannot exercise the stock right because the exercise would violate applicable law or would jeopardize the ability of the employer to continue as a going concern. However, this extension cannot last more than 30 days after the date exercise would no longer violate applicable law or would not jeopardize the ability of the service recipient to continue as a going concern.

Please see our prior Client Alert about stock rights under the final Section 409A regulations.

Rules on Elections to Defer Separation Pay

The deferred compensation rules regarding elections to defer are briefly summarized below. These rules are complex and will be addressed in more detail in our next Client Alert.

32. Are there rules about when an election to defer compensation may be made with respect to separation pay?

When a deferral of compensation subject to Section 409A is made, the election must be made no later than the end of the year before the year for which the compensation is earned in order to comply with Section 409A (and to avoid subjecting the taxpayer to the taxes described above).

With respect to separation pay paid after actual (voluntary or involuntary) separation from service, the final regulations provide that the initial deferral election may be made at any time before the employee obtains a legally binding right to the payment so long as: (1) the employee had no prior right to such separation pay, and (2) the separation pay is subject to bona fide arms-length negotiations.
Separation Pay Arrangements . . .

Continued from page 9...

Therefore, the time and form of payment must be fixed at the time a separation pay arrangement is entered into and before the employee has a choice between a current and a deferred payment.

33. Can an employee change an election with respect to the time or form of payment?

Yes, but in order to comply with Section 409A, any change in the time or form of payments under a separation pay arrangement is required to meet the rules of Section 409A governing subsequent deferral elections and accelerated payments.

Generally, a subsequent election to defer a payment or change the form of payment of an amount of deferred compensation may only be made if: (1) the subsequent payment may not be made less than 12 months before the date the first amount was scheduled to be paid; (2) the election may not take effect until at least 12 months after the date on which the subsequent election was made; and (3) the payment with respect to which the subsequent election is made is deferred for a period of not less than five years from the date such payment would have otherwise been made (the “five-year/one-year” rule).

34. How do we fix the time and form of payment with respect to reimbursement and in-kind benefits?

The final regulations provide that non-taxable reimbursements, certain taxable medical reimbursements, and in-kind benefits generally are not subject to Section 409A if paid within the time period discussed above. However, the final regulations recognize that there are difficulties in fixing the time and form of reimbursement and in-kind benefits to meet such timing requirements. The final regulations provide that a right to reimbursement or in-kind benefits will meet the requirements of a fixed time and form of payment if certain requirements are satisfied. A reimbursement plan must provide for the reimbursement of expenses incurred during an objectively defined period in which the amount of reimbursable expenses incurred or in-kind benefits available in one taxable year cannot affect the amount of reimbursable or in-kind benefits available in a different taxable year. In addition, the reimbursement payment must be made no later than the end of the employee’s taxable year following the taxable year in which the expense was incurred. Reimbursement or in-kind benefit rights may not be subject to liquidation or exchange for another benefit.

For example: A right to reimbursement of membership fees (e.g., for a professional organization) incurred for each of three specified and consecutive calendar years by a former employee, where he or she is entitled to reimbursement of the expenses incurred each year without regard to the expenses year to year, and where it cannot be exchanged for the right to cash or any other benefit, has a fixed time and form of payment, so long as the reimbursement occurs no later than the end of the calendar year following the year in which the expense is incurred. In contrast, a right to reimbursement of membership fees of up to $30,000 over three years would not meet the requirement of a fixed time and form of payment because the extent to which the former employee incurred an expense in one year would necessarily affect the amount available for reimbursement in a subsequent year.

35. Are there written plan requirements under Section 409A for separation pay arrangements?

Yes. The employer must establish and maintain a written plan in compliance with Section 409A if the payments underlying the arrangement are subject to Section 409A. Under the final regulations, an employer establishes a plan on the latest of (1) the adoption date, (2) the effective date, or (3) the date on which the material terms of the plan are set forth in writing. The employer may set forth the material terms of the plan in one or more written documents. The material terms include the amount (or formula to determine the amount) of deferred compensation that the participant will receive and the time and form of the participant’s payment. In addition, with respect to a public company, the plan must specifically provide for a six-month payment delay for “specified employees” (as discussed in question 36 below). Because of this requirement, if you are an employer who has verbal agreements to pay certain amounts of separation pay or benefits which qualify as “deferred compensation,” those agreements should be put in writing by December 31, 2007.

Payment Date Requirements for Specified Employees

36. Are the prior rules requiring delay of deferred compensation payments to “specified employees” adopted by the final regulations?

Yes. The statutory language of Section 409A provides that with respect to specified employees, a payment of deferred compensation on account of a separation from service may not occur before the date that is six months after the date of separation from service. However, the final regulations provide that payments that are excepted from Section 409A are not subject to the six-month delay. As a result, the six-month...
delay may be less painful than previously thought. For example, payments that are made in a single lump sum on an involuntary separation from service or paid in an amount, up to the dollar limits prescribed, under the involuntary separation from service and window program exception can be paid without a six-month delay to a specified employee.

37. Who is a “specified employee”?

A “specified employee” is a key employee of a corporation whose stock is publicly traded on an established securities market. Key employees are determined according to the rules found in Internal Revenue Code Section 416(i), which applies a cap on the number of key employees. Specifically, all 5 percent owners of the corporation, 1 percent owners of the corporation with compensation greater than $150,000, and officers of a corporation with compensation greater than $130,000 will be considered key employees, but no more than 50 officers will be key employees (or, if lesser, the greater of (a) three, or (b) 10 percent of the employees).

The final Section 409A regulations also clarify that officers of foreign subsidiaries may now be excluded from this calculation, although Internal Revenue Code Section 416(i) and the underlying regulations do not make a distinction based on U.S. or worldwide officer status. However, employers might want to include foreign officers when determining key employees (despite the administrative burden in gathering foreign-officer compensation data) to reduce Section 409A exposure to U.S. officers when determining key employees.

Please note that there is a statutory exception that permits an employer to exclude (for purposes of determining the number of officers taken into account), officers who are: (1) employees who have not completed six months of service; (2) employees who normally work less than 17 hours per week; (3) employees who normally work less than 6 months during any year; (4) employees who have not attained age 21; or (5) employees covered by a collective bargaining agreement.

38. If a company is traded only on a foreign stock market, are its employees subject to the “specified employee” rule?

Yes. The “specified employee” rules will apply to the employees of a company traded only on a foreign stock market. This is because the final regulations clarify that an established securities market includes a foreign stock market (e.g., the London Stock Exchange and AIM Market).

39. Are there changes under the final regulations for determining key employees?

The regulations provide that employers can use any definition of “compensation” found in Internal Revenue Code Section 415 (the compensation rules that are normally applicable to tax-qualified retirement plans) for purposes of identifying key employees, provided that the definition is applied consistently to all employees of the employer. Further, the employer may use a definition of compensation for identifying specified employees regardless of whether another Internal Revenue Code Section 415 definition of compensation is being used for purposes of its tax-qualified retirement plan. However, it may be more convenient for an employer to have these definitions match.

40. Are there changes in the final regulations with respect to the specified employee effective date?

The final regulations provide that an employer may use a specified employee effective date that is earlier than April 1. Generally, the employees identified as of an identification date would become specified employees on the April 1 following the identification date. However, the regulations permit an employer to select an earlier specified employee identification date upon which the new list of specified employees will become effective. Any change to the specified employee effective date may not become applicable until 12 months following the initial change.

The regulations provide December 31 as the default specified employee identification date and April 1 following the identification date as the default date for situations in which an employer does not specify a date in its separation pay arrangements and deferred compensation plans.

41. How do we identify an employee who would have become a specified employee if it weren’t for his termination?

The final regulations clarify that the six-month delay requirement applies only when the employee is a specified employee as of the date of the separation from service, even if he or she would have subsequently become a specified employee if the separation had not occurred.

Continued on page 12...
42. How do we treat specified employees after a change of control?

The final regulations significantly alter the identification of specified employees following corporate transactions such as mergers, spin-offs, and initial public offerings (IPOs). The final regulations set forth procedures for determining: (1) the next specified employee identification date; (2) the first specified employee effective date following the merger or transaction; and (3) rules for the period after the date of the merger or transaction and before the next specified employee effective date.

The procedures vary depending on whether the acquirer and target are publicly or privately held. For instance, in a transaction in which both parties are publicly held, the specified employees immediately following the merger generally will consist of the 50 most highly compensated service providers of the combined company, although alternate methods of determining the specified employees may be set within a short timeframe following the merger. On the other hand, when a public company acquires a private company, the list of specified employees immediately following the transaction will be those who were already designated as the specified employees of the public company before the transaction, and the employees from the private company get a “pass” until the next specified employee effective date. There are additional procedures set forth for spin-off and IPO scenarios.

We encourage employers who will be entering into public-public mergers, public-private mergers, spin-offs, and IPOs to consider specified employee determinations and identify any Section 409A impact prior to any such merger or transaction.

43. Can we accelerate the payment of a separation payment if a specified employee dies, becomes disabled, or has an unforeseeable emergency?

Yes. The final regulations retain the prior interim guidance rule that a payment may be made, without any six-month delay, following a specified employee’s death after his or her separation from service (that is, the payment may be accelerated). However, on the occurrence of disability, unforeseeable emergencies, or change of control after a separation from service, the payment must continue to be delayed. On the other hand, payment does not need to be delayed if a payment is initially made due to disability, unforeseeable emergencies, or change of control and a separation from service occurs afterwards.

44. Are there other instances in which we can accelerate a payment for a specified employee?

The final regulations provide that the required delay of a payment to a specified employee after separation from service is not violated in situations in which the payment is made before the end of the six-month required delay period due to a domestic relations order, to satisfy a federal, state, local, or foreign ethics law, or to pay certain employment taxes.

Examples

45. Can you illustrate how some of the separation pay rules work together in a few examples?

Yes. Below are two practical examples of how the rules work. The first example illustrates the use of the separation pay exceptions. The second example illustrates the interaction of the separation pay exceptions with the specified employee rules.

**Example 1.** Pat is the general counsel to a large private company and is located in the United States. Pat’s annual salary and annual bonus total $475,000. Under his employment agreement, Pat is entitled to two times his annual salary and bonus ($950,000) if Pat is terminated without cause or if Pat terminates his employment for good reason, payable over a two-year period beginning immediately following termination of employment. Pat also is entitled to company-paid COBRA continuation coverage for 18 months following termination of employment (value of $23,500). Pat also is entitled to use the company-leased car for its remaining lease term of 12 months (value of $14,000). Therefore, Pat could receive up to $987,500 in benefits under the severance provisions of his employment agreement.

Pat terminates his employment for good reason with the company in 2007 because the company has changed its policies with respect to his duties as head of the legal department. They now require that Pat report to a senior vice president, rather than directly to the board of directors of the company. Under the severance provisions of his employment agreement, such change in duties is considered a material...
Separation Pay Arrangements . . .
Continued from page 12...

and adverse change in Pat’s employment. In addition, under the same severance provisions, Pat must give the company 30 days to cure the material and adverse change. The company does not cure and Pat’s employment terminates.

**Answer to Example 1.** Pat’s payments extend well past the first two-and-a-half months of the calendar year following the year Pat is terminated. As a result, the short-term deferral exception does not apply and some of the payments may be subject to Section 409A. However, other exceptions may apply and (hopefully) reduce Pat’s exposure under Section 409A.

**a. Involuntary separation from service exception**

Pat’s termination for good reason likely will be treated as an involuntary termination because: (1) Pat’s benefits payable after termination for good reason are the same amount and made at the same time and in the same form as payments that would be available after an involuntary separation from service; (2) Pat is required to give notice of the existence of the good reason condition and reasonable opportunity for the employer to remedy the condition; and (3) the action taken by the company in this case probably results in a material negative change in Pat’s employment.

As a result, certain portions of the $987,500 in payments may be excepted from Section 409A because of the involuntary separation from service exception. This exception will be limited in this case to $450,000 (two times the compensation limit of $225,000 set forth in Internal Revenue Code Section 401(a)(17) for 2007). As result, $450,000 of Pat’s severance payments is not subject to Section 409A.

Please note, however, that this agreement does not fall within the new safe harbor found in the final Section 409A regulations because it does not require Pat to provide notice of the existence of the good reason condition within a period not to exceed 90 days from its initial existence. Therefore, this factual determination regarding the finding of good reason by the company could be subject to scrutiny by the IRS in the future.

**b. The non-taxable benefit exception**

The $23,500 in company-paid COBRA continuation coverage for 18 months will not be subject to Section 409A because it is a non-taxable benefit under Internal Revenue Code Section 105 (which does not require current employment to exempt such benefits from taxation). Please note that it is not a taxable benefit under Internal Revenue Code Section 105(h) due to the fact the company’s health plan is fully insured and Internal Code Section 105(h) only applies to self-insured health plans. Therefore, the $23,500 will not be treated as a deferred compensation for purposes of Section 409A. Further, the exclusion of this $23,500 amount will not run concurrently with the aforementioned $450,000 exclusion because these exceptions work on an additive basis.

**c. In-kind benefit exception**

Pat’s entitlement to use the company-leased car for its remaining lease term of 12 months, which is valued at $14,000, will not constitute a deferral of compensation because it is an in-kind benefit under Section 409A. In addition, the car benefit will not be subject to Section 409A because it is provided by the end of the second year following Pat’s separation from service.

Therefore, $500,000 of Pat’s severance payments ($987,500 – (450,000 + $14,000 + $23,500) = $500,000) will be subject to Section 409A, but since the payments will be paid according to the fixed schedule set in Pat’s original agreement (which will make such payments comply with Section 409A), it will not be subject to any additional tax under Section 409A. Overall, $487,500 is not subject to Section 409A.

**Example 2.** Same facts as in Example 1, except that the company’s stock is traded publicly on the New York Stock Exchange and Pat has been one of the top 50 highest-paid officers for several years.

**Answer to Example 2.** Pat should be considered a specified employee because Pat is a U.S. employee and cannot be excluded due to the optional foreign officer exclusion. Further, there are no facts that Pat can be excluded due to the part-time officer exclusions found in Internal Revenue Code Section 416(i). Because the company’s stock is traded publicly, the specified employee rules under final Section 409A regulations apply and Pat will be considered a specified employee. Therefore, any payment subject to Section 409A must be delayed for at least six months after separation from service.

Continued on page 14...
The involuntary separation from service exception, non-taxable benefit exception, and in-kind benefit exception continue to apply. Any payment subject to Section 409A must be delayed for at least six months after separation from service. Therefore, the six-month delay will not apply to the payments representing $487,500 because amounts paid pursuant to the aforementioned exceptions are not subject to Section 409A. However, payments subject to Section 409A must be delayed at least six months from the separation from service date (that is, the separation payments representing the $500,000 must be delayed six months from Pat’s separation date).

Action Items

Employers should perform the following action items within the next several months:

- Inventory all arrangements that provide for separation pay.
- Review all such separation pay arrangements to determine whether they are subject to Section 409A and amend them as necessary to ensure compliance with the final regulations.
- With respect to informal separation pay arrangements, determine to what extent they must now be formalized in a plan or in agreements.
- If the employer is a public company, develop specified employee determination procedures

For More Information

This Client Alert is intended only as a general summary of the impact of the final Section 409A regulations on separation pay arrangements. We strongly advise you to seek professional assistance with respect to your specific issues.

If you have any questions regarding this Client Alert, please contact any member of the Wilson Sonsini Goodrich & Rosati Employee Benefits & Compensation practice:

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