SEYFARTH ATTORNEYS SHAW LLP

# Management Alert

## Final Deferred Compensation Regulations

On April 10, 2007, the IRS issued its long-anticipated Final Regulations governing deferred compensation plans under Code Section 409A ("409A"). The Final Regulations are effective as of April 17, 2007, with transition rules making January 1, 2008 the key compliance date.

Virtually all deferred compensation arrangements must be amended by December 31, 2007 to comply with the new rules. Failure to comply will cause all deferred compensation under the plan (and, because of aggregation rules, under all plans of the same type) to be taxed to the affected individual when it is earned and vested, at normal income tax rates, plus an additional 20% penalty tax (and interest to the extent the 409A violation causes an amount deferred in a prior year to become taxable).

### Highlights

- For public companies, the Final Regulations significantly enhance the ability to pay severance to specified key employees within the six-month period after termination.
- Public companies will need to identify specified employees in advance in order to comply with document requirements.
- The Final Regulations significantly expand the ability to extend the exercise period of a stock option following termination of employment.
- Some common design features will need to be revisited and possibly modified, including offsetting deferred compensation for other debts to the company and cashing out performance-based compensation at involuntary termination.
- Full documentary compliance is required by December 31, 2007.

In 2007, employers will need to review all arrangements which defer compensation including:

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|---|---|---|---|
| Deferred compensation plans | Annual and long term bonus and incentive plans | Stock option and equity award plans | Employment agreements |
| Severance and termination agreements | Commission programs | Post-employment reimbursements | 457(f) plans |
| SERPs and excess plans | Split-dollar life insurance | 401(k) "mirror" or "wrap" plans | Restricted stock units, performance shares |

## Separation from Service and Separation Pay Arrangements

### *Excluded Separation Pay*

One of the most significant changes in the Final Regulations is the exclusion of separation pay from 409A to the extent the pay is: (1) available only upon involuntary separation or participation in a window program of up to 12 months, (2) paid no later than the end of the employee's second taxable year following the year of the separation from service and (3) limited to the lesser of two times the employee's annualized compensation (based on base rate of pay in the prior year) or two times the IRS qualified plan compensation limit (two times $225,000 in 2007).

Thus, if drafted properly, involuntary severance pay up to the cap will not be subject to 409A or to the six-month delay for specified employees of public companies.

The Final Regulations further expand the separation pay arrangements not subject to 409A to include *bona fide* collectively bargained arrangements, certain foreign arrangements, certain expense reimbursement arrangements or in-kind benefits for a limited period, and rights to separation pay up to the 402(g) limit ($15,500 in 2007). Each of these exceptions may be used in combination with the others, and in coordination with the short-term deferral rule discussed below, so that potentially large severance amounts may be excluded from 409A coverage by applying the various exceptions to different component pieces of the severance package.

A word of caution where an employee is receiving separation pay but is also forfeiting deferred compensation: particularly where the separation is voluntary, the Final Regulations create a presumption that the employer is paying the severance in lieu of the deferred compensation being forfeited. This may potentially result in an impermissible acceleration. This presumption can be rebutted by showing that the employee would have received the separation pay without regard to the forfeiture.

### *Separation from Service*

A separation from service occurs upon the retirement, death or other termination of service of the employee. The Final Regulations presume that a termination occurs when the parties reasonably anticipate that no future services will be performed or that the level of services (whether as an employee or an independent contractor) will permanently decrease to no more than 20% of the average level of services performed over the immediately preceding 36-month period (or the full period of services if less than 36 months). The Final Regulations apply a similar presumption that no termination has occurred if the employee continues to provide services at a 50% or higher level. These presumptions are rebuttable. For example, where the parties had anticipated that the employee would not continue providing services, but subsequent business events required that the employee return to his or her prior position, the parties may establish that no termination occurred. A deferred compensation arrangement may set a threshold for termination of employment where the level of services has declined to a level between 20% and 50%.

The "service recipient" for this purpose includes the employer and all entities in its controlled group using the qualified plan definition, but with a 50% ownership or control threshold instead of 80%. The Final Regulations include special rules regarding termination of employment in the multiemployer collective bargaining context, and in connection with a sale of assets or spin-off transactions.

## When Separation from Service is "Involuntary"

A separation from service is "involuntary" if the employer independently exercises its unilateral authority to terminate the employee. This may include the employer's failure to renew a contract provided that the employee was willing and able to renew. Any characterization of the separation from service as voluntary or involuntary by the parties is presumed to be correct, but the presumption may be rebutted where the facts and circumstances indicate otherwise.

## Voluntary Resignation for "Good Reason" Can be Involuntary

The Final Regulations treat certain resignations with "good reason" as an involuntary separation from service. To be an involuntary separation, the employer's actions must cause a material negative change in the employment relationship. The Final Regulations include a facts and circumstances test to determine whether such a change has occurred, but they also provide the following "good reason" safe harbor:

1. The arrangement specifies that the termination must occur within a predetermined period not to exceed two years after the good reason event.
2. The good reason event is limited to specified material negative change events listed in the Final Regulations. Some common good reason terms – particularly a material reduction in opportunity for incentive compensation or benefits – are not included.
3. The amount, time and form of payment is substantially identical to the severance (if any) that would otherwise be paid upon an involuntary separation.
4. The employee provides the employer notice of the good reason event within a period not to exceed 90 days after the event and the employer has at least 30 days to remedy the condition.

Because the Final Regulations treat certain resignations for good reason as an involuntary termination, severance paid upon a good reason termination may qualify for the involuntary separation pay exclusion from 409A discussed above.

## Reimbursement Arrangements and Medical Coverage Post-Employment

409A does not cover any reimbursements excluded from an employee's taxable income. In addition, the Final Regulations provide two other rules that allow reimbursement arrangements common in employment and severance agreements to satisfy 409A. First, the following reimbursement arrangements are excluded from 409A: (a) reimbursement of an expense the employee could otherwise deduct as a business expense, such as outplacement and moving expenses, provided that the expense is incurred by the end of the second year after termination and the reimbursement is made by the end of the third year; (b) reimbursement of medical expenses or the provision of medical benefits within the maximum applicable COBRA period; and (c) indemnification of expenses and claims relating to the employment.

Second, reimbursement arrangements, including tax gross-up provisions, covered by 409A can nonetheless be drafted so as to comply with 409A's requirement that payments be made on a specified date or fixed schedule, if (a) the arrangement provides an objectively determinable, nondiscretionary definition of the expenses eligible for reimbursement or in-kind benefits to be provided; (b) reimbursement is made within one complete year after the year the service provider incurred the expense and (c) the amount of reimbursable expenses paid in one year does not affect the amounts paid in subsequent years (except that the Final Regulations allow a cap on medical benefits).

## Short-Term Deferrals

The short-term deferral exception excludes from 409A amounts paid within 2-1/2 months after the end of the employee's taxable year or the employer's taxable year (whichever is later) in which the compensation is no longer subject to a substantial risk of forfeiture. The Final Regulations clarify that actual payment within the short-term deferral deadline does not exempt a payment from 409A if the payment could have been made on or after a date or event that will *or may* occur after the end of the short-term deferral period. The exemption from 409A still applies if payment delays occur due to unforeseeable administrative delays or, new under the Final Regulations, to prevent loss of the deduction to compensation over $1M under Code Section 162(m). Employers frequently use this exception to exclude bonus and severance payments from 409A. The Final Regulations provide a number of examples that indicate how bonus plan provisions regarding timing of payment can affect whether the bonus satisfies the short-term deferral exception or not. In one example, a bonus plan that specified a payment date after March 15 provided 409A deferred compensation even if the payment was made on or before March 15. Careful drafting of bonus and incentive arrangements will be important.

## Timing of Deferral Elections

The basic framework and deadlines for filing deferral elections remain intact with some minor relief and technical modifications. Deferral elections must still be made in the individual's taxable year that precedes the year in which the services are performed. However, when compensation (other than salary) is earned on a fiscal year basis, the deferral election must be made before the start of the fiscal year in which the services are performed. The time and form (but not medium) of payment for both elective and non-elective plans must also be established by the applicable deadline. The Final Regulations provide that when an individual does not have the right to make a payment election, the employer (or the plan document) must specify the time and manner of payment before the individual has a legally binding right to the compensation, or if the individual would have been required to make the election, the applicable deadline (whichever is later).

### *First Year of Eligibility*

The Final Regulations retain the rule that a newly eligible participant in a plan may make deferral and payment elections within the first 30 days after becoming eligible to participate, but liberalize how the rule applies. First, whether a participant is newly-eligible is determined based on eligibility for all plans of the same type. In a generous response to critics of the Proposed Regulations, the Final Regulations modify the plan aggregation rules by increasing the categories of plans and arrangements from four to nine:

| | | |
|---|---|---|
| Elective account | Separation pay | Stock rights (options & SARs) |
| Non-elective account | Reimbursements | Foreign |
| Non-account balance | Split-dollar life | Other |

The split in the account balance plan category allows employers to treat, for example, a match or non-elective contribution as separate from the elective deferral portion.

Besides increasing flexibility for deferral elections for initial eligibility for various plans, these new aggregation rules also ease other aspects of administration, including cash-outs and plan terminations. Since a 409A violation triggers taxation for all plans of the same type, the expanded categories should reduce the impact of noncompliance.

Second, the Final Regulations provide that a participant will first be eligible for an "excess benefit plan" as of the first day of the taxable year after the year in which he first accrues the excess benefit (generally, January 1). As such, a participant will have until January 30 to make any payment elections. The definition of "excess benefit plan" in the Final Regulations captures non-elective SERP plans that wrap around a qualified plan to provide a benefit that *solely* provides a benefit in excess of the qualified plan benefit by disregarding any Code limit. (Note that the definition of excess benefit plan in the Final Regulations is broader than ERISA's definition, which includes only plans which provide benefits in excess of the Code Section 415 limit.) In this regard, if an employer maintains a SERP that provides for a different formula (whether or not it offsets a qualified benefit) or provides a benefit in excess of any other qualified plan term, this rule would not apply and a participant must make any payment election within 30 days after he or she becomes eligible for the plan.

Third, the Final Regulations provide clarifying rules to address when a rehired employee can again be treated as "newly-eligible."

## *Performance-Based Compensation*

For performance-based compensation measured over a minimum 12-month period, a participant's deferral and payment elections must be made no later than six months before the end of the performance period (generally, June 30 for a calendar year performance period). Under the Final Regulations, the election must be made before the compensation is "readily ascertainable," meaning before the performance-based compensation is both capable of calculation and substantially certain to be paid. This could affect an incentive program where threshold performance criteria are met during the performance period, resulting in a quantifiable performance bonus due, and the only unknown component is what multiplier may apply to the target compensation. In that case, the deferral election could relate only to the additional amount of bonus not readily ascertainable at the time of the election.

Note that incentive pay that will be paid regardless of satisfaction of performance criteria for any reason other than death, disability or change in control is not treated as performance-based compensation. This will be an issue for plans that pay at target upon retirement, involuntary termination or termination after a change in control using a definition that is inconsistent with the definition in the Final Regulations.

## *Deferring Unvested Awards and Short-Term Deferrals*

The Final Regulations retain the rule allowing arrangements for an employee to elect to defer an award of compensation within 30 days after the award is made, provided that the award would not vest for a minimum of 12 months from the election date. This rule is helpful for deferral rights associated with, for example, a grant of performance shares or restricted stock units subject to a two-year (or longer) cliff vesting schedule. If the award may vest before the 12-month mark due to death, disability or change in control, the deferral election will still be valid. Similarly, an arrangement may permit an employee to elect to defer an amount that would otherwise be a short-term deferral, if the election is made at least 12 months before the payment would vest and the deferral election provides a payment date that is at least 5 years after that date.

### *Negotiated Payments*

When separation pay for either a voluntary or involuntary separation is subject to a bona fide, arm's length negotiation, deferral and payment elections, if any, must be made before the individual has a legally binding right to the pay. In the case of a window program, elections must be made before the election to participate in the program becomes irrevocable. This rule allows "ad hoc" severance agreements, but beware if other severance or deferred compensation is given up in the negotiation.

## Time and Form of Payment

Consistent with the statute, the Final Regulations require payments to be made on a specified date or fixed schedule, or upon death, disability, separation from service, change in control or unforeseeable emergency. Time and form of payment may be elective or non-elective, provided they are established by the applicable deadline discussed above. A specific date, period or not more than 90 days, or year may be designated for payment. However, if a plan designates a specified period, then the distribution date is deemed to be first day of such period for re-deferral purposes (see below). The Final Regulations set the change in control minimum percentage triggers at 30% of stock (instead of 35%) for a change in effective control, keeping 50% for a change in ownership and 40% for a sale of assets.

The Final Regulations retain the option to provide for payments to begin either "at the earlier of" or "at the later of" one or more specified times or permitted 409A events. An employee may also elect different payment forms for each payment time or event. The redeferral rules apply separately to each payment time and form.

### *Specified Time/Fixed Schedule*

The Final Regulations continue the objectively determinable standard for determining whether a plan provides for a specified time or fixed schedule. The Proposed Regulations treated a payment as made on a specified date or fixed schedule if made by the end of the calendar year including the specified date or due date under a schedule or, if later, by the 15th day of the third calendar month following the specified date. The Final Regulations clarify that this rule applies equally to payments made upon a specified event. In addition, the Final Regulations will not treat a payment as an accelerated payment, if it is made up to 30 days earlier than the designated date, provided that the employee has no ability to determine the taxable year in which the distribution will occur.

The Final Regulations also clarify how payments in various circumstances, including reimbursements or in-kind benefits, payment schedules with fixed or formula payment limitations, and tax gross-up payments can be structured to satisfy these rules. The Final Regulations also provide limited circumstances under which a schedule that is based upon the timing of payments to the employer will be considered to be a fixed schedule.

### *Unforeseeable Emergency*

The Final Regulations provide that a distribution may not be made if the emergency can be relieved through reimbursement or compensation from insurance, by liquidation of the employee's assets (to the extent liquidation would not cause a severe hardship) or by ceasing deferrals under the deferred compensation arrangement (which is permitted). However, the availability of benefits under another non-qualified or qualified plan (including hardship withdrawals from a 401(k) plan), need not be taken into account. Following the modifications to the Pension Protection Act of 2006, the Final Regulations permit distributions for unforeseeable emergencies of an employee's beneficiary who is not the employee's dependent for tax purposes.

## *Changes to Time and Form of Payment Elections*

The Final Regulations retain the general criteria for making subsequent payment election changes, which require any payment election change to be made at least 12 months before the payment is to be made with a minimum five year deferral period, and clarify that they also apply to beneficiaries. The five year minimum redeferral rule only applies to payment election changes where the original payment is upon separation from service, change in control or pursuant to a specified date or fixed schedule. For purposes of electing to delay payment timing, installment payments can be treated as a single payment event unless a plan provides otherwise. Therefore, individuals may change an installment payment election to a lump sum if the payment is deferred at least five years from the date the first installment was scheduled to begin.

It should be noted, however, that when designing a severance arrangement where the employer wishes to take advantage of the short-term deferral period for excluding some termination payments from inclusion in the severance amount calculation, an employer may choose to treat each installment as a separate payment. If this is desired, then the plan document must explicitly include this provision.

The Final Regulations also continue to treat annuities as a single payment and do not apply the delay to an individual choosing among actuarially equivalent life annuities at any time before the first day the annuity is scheduled to be made (as long as the date is not changed).

## *Six-Month Delay for Specified Employees*

For public companies, 409A requires distributions to "specified employees" to be delayed at least six months after a separation from service (other than due to death). Specified employees are "key employees" under Code Section 416(i). The employer must identify specified employees as of a given "identification date," and specified employees as of such date will continue to be specified employees for the designated 12 month period that begins within four months of the specified employee identification date. The same specified employee identification date and 12-month period must apply to all of the employer's nonqualified deferred compensation plans. Because the six-month delay rule must be in the applicable plan document, it will be necessary for public employers to draw up an annual list each year.

The Final Regulations set out processes for determining the group of specified employees after a merger, spin-off or public offering, detailing not only the resulting group of specified employees, but also the subsequent specified employee identification date.

The Final Regulations allow an employer to designate all employees or a sub-group of up to 200 identified employees as specified employees, rather than requiring a specific person-by-person determination under Code Section 416(i). However, the sub-group must include all employees who would be specified employees under Code Section 416(i). This may be helpful for controlled groups with different lines of business that do not share compensation data. If an employer wishes to be even more inclusive to avoid identifying key employees, as by requiring a six-month delay for all employees, the plan must be amended by December 31, 2007.

## *Permitted Delays and Accelerations in Payments*

The Final Regulations expand the circumstances under which employers are permitted to delay payments without violating the rule that deferred compensation may be paid only at a fixed date or under a fixed schedule, including, for example, where such payment would jeopardize the employer's ability to continue as a going concern, where the payment would violate securities laws and where the employer and the employee dispute the terms of the payment.

Generally, 409A prohibits the acceleration of payments under a deferred compensation plan. The Final Regulations clarify that payments may be considered accelerated if deferred compensation is reduced or applied to offset a debt the employee may otherwise owe to the employer (or another entity). As a result, any offset provisions in a deferred compensation arrangement should be reviewed carefully. The Final Regulations also modify the permitted circumstances under which the employer may have the discretion to accelerate payments, particularly by increasing the pre-established cash-out limit from $10,000 to the Code Section 402(g) limit for 401(k) deferrals ($15,500 in 2007).

### *Settlements and Bona Fide Disputes*

Amounts received in settlement of a lawsuit will not be deferred compensation as long as the settlement is not substituting for, or restructuring, a preexisting deferred compensation plan. In the case of a bona fide dispute over whether amounts are due under a deferred compensation plan, amounts may be accelerated where there is a settlement of the dispute but only with respect to the portion in dispute. This relief does not apply to disputes over when a payment is due (only as to the amount). Also, there must be a substantial reduction in value of the disputed amount for it to be accelerated. If the reduction in full value is less than 25% it will not be considered a substantial reduction for this purpose.

## Arrangements Linked to Qualified Plans

Changes to Internal Revenue Code limits on qualified plans which have a corresponding effect on contributions or benefits under a deferred compensation arrangement will not violate 409A. The Final Regulations extend this linked plan relief to broad-based foreign retirement plans. Also, if benefit formulas in deferred compensation plans are affected by amounts credited to the employee's account under a qualified plan (including pre-tax deferrals and after-tax and catch-up contributions) the deferred compensation plan account can be adjusted provided that (i) a change in the amount deferred under the deferred compensation plan does not result in a change in time or form of payment, and (ii) the change in amount deferred by the employee under the deferred compensation plan does not exceed the amount of the change in the linked qualified plan. However, where the additional amounts under the deferred compensation plan reflect only matching amounts which would have been available under the qualified plan but for testing limitations, relief is provided solely with respect to those matching amounts. Relief from 409A is also provided when the employer's or employee's action or inaction affects the availability of an ancillary or subsidized benefit under a qualified plan. Employers should carefully review wrap or mirror 401(k) plans to meet the limitations.

## Stock Awards

### *Extension of Option Exercise Period*

Under 409A, the extension of the post-termination of employment exercise period of a stock option is viewed as adding an additional deferral feature to the option. The Proposed Regulations allowed for a de minimis extension of the post-termination of employment exercise period before an option became retroactively subject to 409A. In a warmly-received and significant change, the Final Regulations allow a stock option exercise period to be extended after grant up to the earlier of the latest date upon which the option could have been exercised in any circumstances under the original term of the option or ten years from the original grant date. The extension of the exercise period of an underwater option is also permitted as the Final Regulations treat the extension as the grant of a new option with the result that its term may be extended without implicating 409A. Given that options typically have a seven or ten year maximum term, the final rules provide parties with significant flexibility in negotiating separation agreements.

## *Service Recipient Stock*

To be exempt from 409A a stock right of a public or private company must be issued with respect to "service recipient stock." The Final Regulations generally expand the types of stock over which stock rights may be granted without triggering the application of 409A. First, the Final Regulations broaden the classes of common stock that may be used for this purpose to include common stock that is subject to certain buy back rights or transferability restrictions and no longer mandate the use of the publicly traded stock of a controlled group member or the common stock with the highest aggregate value. Common stock with liquidation preferences also now qualifies as service recipient stock. However, common stock with other preferences (such as dividend preferences) continues not to meet the rules. ADRs may qualify as "service recipient stock." Finally, the list of permissible issuers of stock rights has been expanded. While the Final Regulations still require a significant nexus between the issuer and the employer corporation, the controlling interest ownership required has been lowered from 80% to 50%. The favorable exception to this minimum ownership interest requirement for bona fide joint venture situations (which may be as low as 20%) continues to be available. The Final Regulations clarify, however, that while an employee of a subsidiary corporation may be granted stock rights over common stock of the employer corporation or any upstream corporation (within the allowed chain of corporations) up to the ultimate parent. Rights over stock of lower-tier subsidiaries do not satisfy the definition of service recipient stock. For example, employees of a parent corporation cannot receive options for stock of a subsidiary operating company whose stock is traded on an established market and retain the 409A exemption. Employer groups which establish a management services entity organizational structure may also find trouble in trying to grant options of such entity. Stock rights granted on or after April 10, 2007, must comply with the service recipient stock definition of the Final Regulations.

## *Statutory Stock Options*

Incentive stock options (ISOs) are not subject to 409A. However, under the Final Regulations the modification of an ISO will subject the option to 409A if the same modification to a non-ISO option (nonqualified option) would cause it to become subject to 409A. Qualified Code Section 423 stock purchase plans remain exempt from 409A treatment, but the Final Regulation gave no relief for broad-based employee stock purchase plans that use a discounted purchase price but do not meet the requirements of Code Section 423, such as UK Sharesave schemes.

## *Valuation*

For a stock option to be exempt from 409A the exercise price must not be less than the fair market value of the underlying stock on the date of grant. Little has changed with respect to establishing fair market value for public company stock options. Any reasonable method using actual market-reported transactions will suffice such as the closing price on the trading day before or the trading day of the grant. Fair market value also may be determined using an average selling price over a specified period not to exceed 30 days before or after the applicable valuation date; provided, that the commitment to grant the stock right with this method of determining the exercise price is made before the beginning of such period. Concessions were made to the rules requiring irrevocable commitments to the extent necessary to comply with applicable foreign laws.

The valuation of stock of nonpublic companies requires only the reasonable application of a reasonable valuation method. A valuation by an independent appraiser or adherence to one of the other two private company valuation safe harbors is not necessary. Use of one of the three safe harbor methods is generally advisable, however, because they continue to establish presumptive fair market value absent a showing by the IRS that the valuation is grossly unreasonable.

The safe harbor valuation applicable to illiquid stock of start-up corporations was favorably changed. Rather than conditioning the presumption upon an expectation that the corporation will not undergo a change in control event or make a public offering of securities within 12 months of a valuation, the Final Regulations require that a change in control event not be reasonably anticipated in the next 90 days, and that an IPO not be reasonably anticipated in the next 180 days. However, the Final Regulations now require that the person valuing the illiquid stock of a start-up corporation have at least five years of relevant experience and meet a reasonable person reliance test.

Private companies may choose to use one valuation method for establishing an exercise price, and another method for purposes of establishing the purchase price under a buy-back arrangement. The Final Regulations allow reliance on either the Proposed Regulations or the Final Regulations for establishing fair market value of stock rights through December 31, 2007. Thereafter, the Final Regulations apply.

### *Other Stock Right Issues*

Conditioning the right to accumulated dividend equivalents upon the exercise of a stock right will be treated as a reduction in the exercise price thereby causing the stock right to be subject to 409A. Even if not so conditioned, the right to dividends must separately satisfy 409A within the plan document, the grant agreement, or in another document.

The substitution of a stock appreciation right for a stock option generally does not impact whether the arrangement is covered by 409A. The new rules expressly permit employers to offer employees a choice between stock options not subject to 409A and restricted stock.

The Final Regulations state that the ability to defer gain upon the exercise or exchange of a stock right is incompatible with the stock rights exception under 409A. Accordingly, an arrangement that provides for a potential to defer the payment of cash or property upon the exercise or exchange of a stock right beyond the year of exercise (or beyond the original term of the stock right) must meet 409A's general requirements at the time of original grant. Exceptions may apply if deferral of payment is necessary to avoid violation of applicable law.

## Unanswered Questions

While the Final Regulations provide much needed clarity, they leave many unanswered questions. Chiefly, the Final Regulations do not address:

- Partnerships and the transfer of partnership interests.
- Calculation and timing of amounts required to be included in income for a violation of 409A.
- Reporting and withholding requirements.
- Definition of a *bona fide* compensatory time off arrangement.
- Prohibition of offshore trusts.
- Use of protective financial triggers which insulate a plan as employers approach bankruptcy or become bankrupt.

## Documentary Compliance

### *Amendment Deadline*

The Final Regulations require plan document compliance no later than December 31, 2007. Restated or amended plans may have a January 1, 2008 effective date. However, for any action taken during the transition period which affects an existing plan on or after January 1, 2008 (such as an election in 2007 to further defer compensation to 2013), the amendment or restated document must incorporate the change. Otherwise, the taxpayer must only substantiate operational compliance during the transition period with 409A.

### *Written Plan Requirement*

The Final Regulations require each deferred compensation arrangement to include a written document which explicitly must include some provisions and may include others, as outlined below. Employers should review documents which they revised for the Proposed Regulations to determine whether the documents include the necessary provisions.

All deferred compensation arrangements must set forth the time, form and amount of payments, timing and conditions of deferral elections and, for separation pay plans, the payment terms which support any exemption from 409A. Under the Final Regulations, certain provisions must be in a plan document to be used, including, ordering of payment events, payment of tax gross-ups and certain reimbursement arrangements, and any payment acceleration permitted under 409A. Employers also should review and revise, as necessary, "good reason" and "Change in Control" definitions. For public companies, severance payments should be explicitly structured to take advantage of the cumulative operation of exemptions from 409A to identify which payments are not subject to the six-month delay rule. Also, the plan document should include the six-month delay rule and the method for determining specified employees.

Employers with arrangements using the short-term deferral exception should also consider having a written plan document. For example, for annual bonus plans that make payments toward the latter part of the short-term deferral period or as soon as administratively feasible thereafter, the written plan requirement is important. If an employer pays a bonus after the expiration of the short-term deferral period, the bonus plan would be subject to 409A and, therefore, must have a written plan document.

The Final Regulations specify that "savings clauses", which purport to automatically provide or override any plan terms not meeting necessary legal requirements (in this case, the 409A rules), are are treated as null and void and will not work for 409A compliance purposes.

For new deferred compensation arrangements and for undocumented plans, the Final Regulations contain rules for determining when a plan is "established" by reference to adoption date, effective date and the date when the plan is set forth in writing. Employers will need to examine the timing under these rules which will make "retroactive" documentation difficult.

*If you have any questions concerning this Management Alert, please contact the Seyfarth Shaw LLP employee benefits attorney with whom you work or any employee benefits attorney on the website at www.seyfarth.com.*

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