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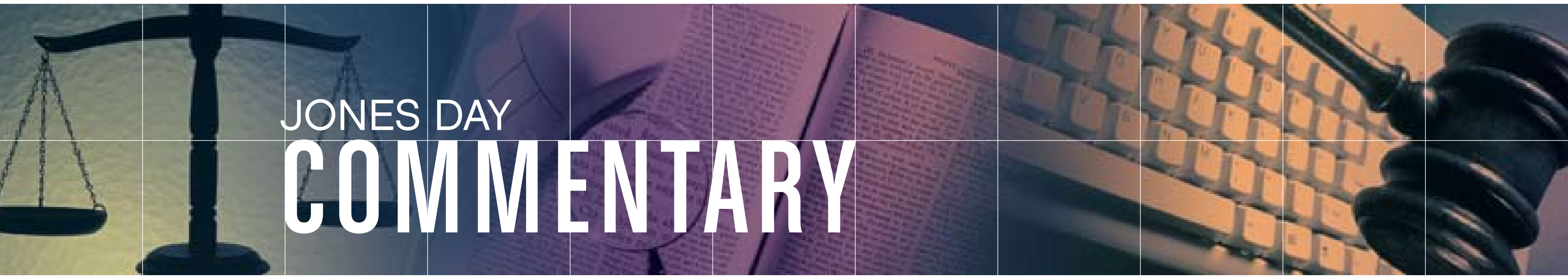

SECTION 409A'S IMPACT ON EMPLOYMENT AGREEMENTS AND SEVERANCE ARRANGEMENTS

Section 409A of the Internal Revenue Code, enacted on October 22, 2004, is the latest effort to regulate executive pay practices through the federal tax system. Three prior *Jones Day Commentaries* have addressed Section 409A and certain of its aspects.

This *Commentary* focuses on how Section 409A applies to employment agreements, severance agreements, and other similar plans or other arrangements providing for a deferral of compensation. Failure to account for Section 409A's impact can seriously and adversely affect the economics of such an arrangement.

What is Section 409A and why does it warrant such special attention? Section 409A sets forth new rules regulating nonqualified deferred compensation. It warrants special attention for two reasons. First, Section 409A regulates deferred compensation through a large number of detailed rules. This is in sharp contrast to the state of the law prior to Section 409A, when there were few specific tax rules in this area. The proposed regulations interpreting Section 409A total 240 pages. Final regulations may be longer. Some of the rules are difficult to apply; others are not. Regardless of difficulty, though, these rules must be considered in designing and drafting employment and severance arrangements.

Second, noncompliance with Section 409A may trigger massive tax penalties on the employee.[1] For example, in addition to a 20 percent penalty tax on the particular payment or benefit that fails to comply with Section 409A, noncompliance in most cases will taint other payments or benefits received by the employee and subject them to the 20 percent penalty tax as well. One small violation therefore could subject a

1. Section 409A can apply also to independent contractors, including directors and partners.

much greater amount of payments or benefits received by the employee to a 20 percent penalty tax. Neither employer nor employee expects this burdensome added layer of tax.

SECTION 409A OVERVIEW

Section 409A operates in three steps. First, it expansively identifies "deferred compensation" subject to its rules, qualified by numerous complex exceptions. Second, it prescribes detailed rules that primarily focus on when such compensation may be paid. Third, in the event of noncompliance, it imposes severe adverse tax consequences on the employee.

With respect to the first step, Section 409A broadly defines "deferred compensation" as all compensation in which an employee obtains a contractual right in one year but which is received in a subsequent year. The fact that the contract right when granted is subject to a risk of forfeiture or other contingencies generally does not preclude classification as deferred compensation.

This definition is then cut back by a series of exceptions that contain numerous detailed requirements. For example, one exception excludes from the definition of deferred compensation separation pay paid on account of an involuntary termination but *only* if: (1) the aggregate payments do not exceed the lesser of two times the executive's annual compensation or $440,000 (indexed) and (2) all payments are made no later than December 31 of the second calendar year following the year of termination. Another exception commonly referred to as "the short-term deferral exception" excludes compensation that is paid within two and a half months of the end of the calendar year in which the compensation became vested (or, if later, within two and a half months of the end of the company's tax year in which the compensation became vested), provided the arrangement does not otherwise defer the payment to a later year.

Once deferred compensation has been identified, the next step is to apply the detailed rules that govern when such compensation may be paid. Section 409A limits the payment date to one of the following six events: (1) separation from service, (2) disability, (3) death, (4) a date or fixed schedule established at the time of deferral, (5) change in control, or (6) unforeseeable emergency. If deferred compensation is or may be paid at a different time, it violates Section 409A. Rules for designating or electing the time and manner of payment and when and how a designated time or manner can be changed are also set forth. A change that would accelerate the time of payment is particularly difficult.

As noted above, one of the permissible payment dates is separation from service. Section 409A, however, provides in the case of a top-50 officer, or certain significant shareholders, of a public company that payments of deferred compensation to be made at separation from service *must* be delayed for at least six months after separation from service. Unless an exception like the short-term deferral exception applies, it is a violation of Section 409A if the payment to a top-50 officer is made at the time of the officer's termination of employment. This clearly is a trap for the unwary.

The final step of Section 409A focuses on the penalties in the event of noncompliance. As noted above, the penalties are imposed on the employee and are quite severe. A 20 percent penalty tax is imposed with respect to the payment or benefit that fails to comply with Section 409A. In addition, the employee generally will be taxed at the time of vesting (rather than receipt) of the payment, and interest will be imposed at a penalty rate. In addition, noncompliance with respect to one payment or benefit may taint other payments and benefits and subject them to the Section 409A penalties. Section 409A determines the extent of the taint by placing each payment or benefit of deferred compensation into one of several baskets. A violation of Section 409A with respect to one payment or benefit in a basket taints all of the other payments or benefits in that basket. The results can be catastrophic.

APPLICATION TO SEVERANCE BENEFITS

Section 409A is particularly difficult to apply in the case of severance benefits. Severance benefits for these purposes include, but are not limited to, (1) cash paid in a lump sum or installments, (2) continuation of medical insurance coverage, (3) continuation of other benefits (*e.g.,* use of an automobile), (4) in kind benefits (*e.g.,* outplacement or financial counseling), (5) accelerated vesting and extension of stock option terms and (6) contingent benefits (*e.g.,* golden-parachute excise tax gross-up or indemnification for legal fees). An employee may be entitled to such benefits either under the terms of his or her employment or severance agreement or pursuant to the terms of a plan.

In nearly all cases, severance benefits will fall within the broad definition of deferred compensation for purposes of Section 409A. A key issue then will be whether the payment or benefit qualifies for one of the exceptions from Section 409A, such as the exception for limited separation pay or the short-term deferral exception. Otherwise, the payment or benefit may need to be restructured to comply with the Section 409A payment rules. In some cases, it may not be possible to comply with the payment rules. If an exception is relied upon, meeting all of the requirements is critical. The stakes are significant. If the payment or benefit qualifies under the exception, payment may be made immediately upon termination. If not, and the employee is a top-50 officer of a public company, payment at termination would be a Section 409A violation due to a failure to satisfy the six-month delay requirement.

Each of the exceptions contains a number of detailed requirements. To qualify for the limited separation pay exception, the payments must be made on account of an involuntary termination (a termination by the employee for good reason apparently is not sufficient), the aggregate payments cannot exceed two times the executive's annual compensation for the year prior to termination or $440,000 (care must be taken to ensure all separation pay benefits are aggregated for this purpose), and all payments must be made no later than December 31 of the second calendar year following the year of termination (again, care must be taken to ensure that all separation pay benefits are considered).

With respect to the short-term deferral exception, a lump sum amount payable at termination should qualify for the exception no matter how large the amount. This is clearly the result where the lump sum is payable only on an involuntarily termination by the employer. Some practitioners have expressed the concern that the exception may not be available if there is a possibility that the payment also could be made in the event of a termination by the employee for good reason. The IRS has been asked to address this issue.

The continuation of benefits after termination of employment also raises a number of difficult issues. Medical insurance coverage is the most commonly continued benefit. The new Section 409A rules permit continued medical coverage provided that certain requirements are met. The particular requirements will depend on whether the medical coverage is provided through an employer self-funded plan or through third-party insurance.

The continuation of other benefits (*e.g.*, use of an automobile) raises more challenging issues and should be undertaken only with careful consideration of Section 409A. The continuation of such benefits often will run afoul of Section 409A, since payment will not be limited to one of six permitted distribution dates. In-kind benefits and contingent benefits raise similar concerns and also should be carefully scrutinized for compliance with Section 409A. For example, at present it is unclear how to provide legal expenses and excise tax gross-up payments in a traditional reimbursement format that complies with the Section 409A rules.

It is also common in severance situations for an employer to agree to accelerate the vesting of stock options and/or to extend the period after termination of employment in which the employee may exercise such options. These actions illustrate the difficult nature of the Section 409A rules. The Section 409A rules expressly permit the accelerated vesting of option awards. By contrast, under proposed rules, an extension of the period to exercise an option will constitute a Section 409A violation unless the exercise period is not extended beyond December 31 of the year in which the right otherwise would have expired (or, if later, the 15th day of the third month following the date on which the right otherwise would have expired).

One final note on severance arrangements. In some cases, in order to provide continued benefits or allow an employee to "grow into" eligibility for retiree benefits, employers will agree to continue the status of an employee as a "deemed employee" for some period of time even though the employee ceases providing active service. Such an arrangement needs to be reviewed with utmost care (and probably should be avoided). The IRS could view any benefit provided under such a deemed-employee arrangement as a severance benefit and subject it to the rules described above (with it likely being a Section 409A violation).

IMMEDIATE ACTION REQUIRED

In light of the above, there are two action points. First, new plans and agreements must be drafted with Section 409A in mind. One approach that may merit consideration is to simplify the severance benefits to be provided in an attempt to ensure Section 409A compliance. Compliance may be easy to achieve if the only severance benefit is a lump-sum cash payment paid on an involuntary separation from service, or if the parties are willing to limit the severance benefits so as to fit within the limited separation pay exception. If more elaborate severance benefits are desired, however, it will be necessary to call in the Section 409A experts.

Second, a review of each existing agreement and plan must be conducted. Section 409A generally became effective January 1, 2005. Only in rare cases will an existing severance or employment agreement be exempt from Section 409A on a grandfathered basis. Instead, most existing agreements will need to be amended to comply with Section 409A. While operational compliance is sufficient currently, the deadline for Section 409A documentary compliance is December 31, 2006. If a noncompliant provision is not removed or corrected by December 31, 2006, it may then be too late to fix the problem even if the defect is identified before an actual payment is made.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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