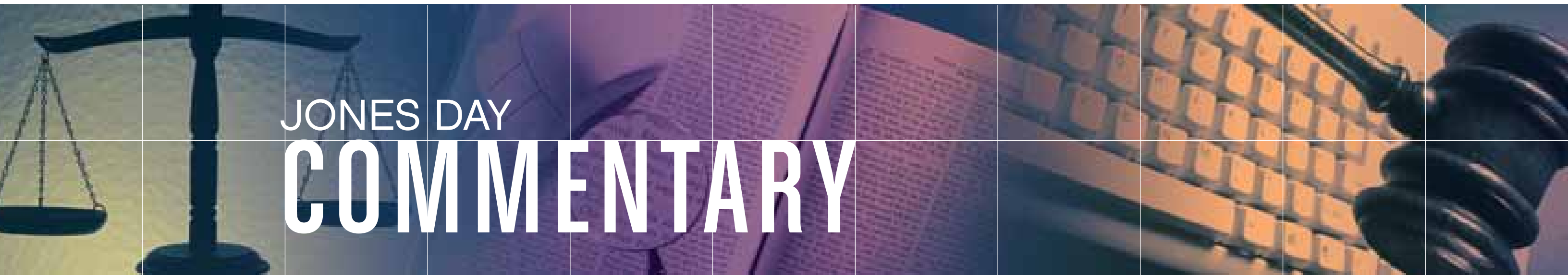
JONES DAY

OCTOBER 2009



EXECUTIVE COMPENSATION TAX RULES MAY REQUIRE YEAR-END PLANNING

As 2009 winds down, companies should consider a number of executive compensation tax rules that are sensitive to year-end deadlines. This *Commentary* discusses (i) planning opportunities under Code Section 409A to address potential tax rate increases on deferred compensation, (ii) how typical severance benefits, including bonus termination payments, may cause problems under the Code Section 162(m) $1 million deduction cap (the "$1 Million Cap"), and (iii) the need to consider the IRS' corrections program for Code Section 409A operational failures.

COMPENSATION: DEFER, ACCELERATE, OR STAND PAT?

With federal budget deficits growing at unprecedented rates, tax increases seem all but inevitable. The Bush administration's tax reductions are due to expire at the end of 2010. The Obama administration has proposed retaining existing rates only for married taxpayers earning not more than $250,000 per year ($200,000 for individuals). As a result, executives have become sensitive to the possibility of future tax rate increases. Since deferral and acceleration of compensation are now rigidly controlled by Code Section 409A, compensation timing decisions, to the extent available, should be carefully weighed. Here are some observations as we near the end of the first year fully subject to Code Section 409A, without the flexibility afforded by the now-expired Code Section 409A transition rules:

- Amounts grandfathered under Code Section 409A may be paid out in 2009 if the applicable plan document provides for the ability to make such payments.

- Elections to defer compensation to be earned in 2010, to the extent available, are generally due by December 31, 2009. Regardless of notional earnings on deferrals and other favorable factors, future tax rates also should be considered in evaluating deferral opportunities.

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- Subject to stringent limitations, a deferred compensation plan may be terminated for all participants. Among the requirements, no payments may be made for at least 12 months after the plan termination date (other than previously scheduled payments), and all payments must be completed within 24 months; the employer cannot be experiencing financial difficulty; all plans in the controlled group that are aggregated with the target plan (sometimes referred to as "like-kind" plans) also must be terminated; and no like-kind plan may be adopted for at least three years after the plan termination date.[1]

- It may be possible to revise payment timing for nonvested compensation without adverse tax consequences under Code Section 409A.

$1 MILLION CAP ON CERTAIN EXECUTIVE PAY

Generally, Code Section 162(m) provides an exemption from the $1 Million Cap on certain executive pay for payments that qualify as performance-based compensation. On February 21, 2008, the IRS published Revenue Ruling 2008-13 (the "Ruling"), which reversed taxpayer-favorable results in two earlier private letter rulings. The Ruling held that a bonus paid to an executive would not qualify as performance-based compensation if the executive is also entitled to payment of the bonus at target upon retirement or an involuntary termination of employment (including a termination for good reason), even if the executive remains employed.[2]

As a result of widespread criticism of the imminent change in the IRS' position, the Ruling included significant transition relief. The new IRS interpretation does not apply to performance periods beginning on or before January 1, 2009. In addition, the payment of performance-based compensation is exempt from the new interpretation if such compensation is subject to the terms of an employment agreement or similar arrangement as in effect on February 21, 2008, without regard to subsequent renewals or extensions, including automatic renewals or extensions. Thus, for most calendar-year public companies, the IRS' new position will first apply to performance periods beginning on or after January 1, 2010, unless the employment agreement transition rule provides further relief.

In view of the impending expiration of the transition relief provided under the Ruling, public companies should review all incentive plans that are intended to be exempt from the $1 Million Cap and examine all individual employment, severance, and other agreements and plans that cover individuals whose compensation may be subject to the $1 Million Cap. Any provision that could violate the new IRS position, such as target bonus payments due on retirement or an involuntary termination of employment, should be identified.[3]

What types of bonus termination arrangements will satisfy the requirements of the Ruling? Unfortunately, informal statements made by IRS representatives have created some uncertainty. We believe, however, that a bonus termination payment based upon the amount that would have been paid on actual attainment of performance goals as if the executive had remained employed through the balance of the performance period should satisfy the new IRS standards. While this approach will often require a delay in payment of the termination bonus, it should be possible to structure the arrangement to satisfy the requirements of Code Section 409A.

The IRS also has indicated some concerns if an executive is entitled to a severance payment that is based on a current target bonus or on an average of recently earned

1 As a result of the 12- and 24-month requirements, in order to ensure that a plan termination causes income to be taxed prior to 2011, the termination date must occur no later than December 31, 2009.

2 We previously addressed this subject in a February 2008 *Jones Day Commentary*, "IRS Changes Position on Key Section 162(m) Issue," *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4920.

3 Under existing tax regulations, payments due on death, disability, or a change of ownership or control are not subject to the new IRS position.

bonus payments, presumably because this could be viewed, depending on the facts and circumstances, as a potential indirect payment of the incentive compensation that is not based on the actual attainment of performance goals. We believe that in most cases, the IRS' concerns should not present a problem. The specific facts and circumstances, however, must be examined. Moreover, we believe that the existence of an express bonus termination payment obligation based on actual attainment of performance goals, as discussed above, should provide strong evidence that there is no indirect payment of the incentive compensation. Nevertheless, the IRS' views are important and continuing to develop (in our view, in a somewhat misguided direction thus far). Companies will need to be sensitive to the risks as compensation arrangements and the establishment of performance-based compensation are reconsidered in light of the IRS' new position.

CODE SECTION 409A CORRECTIONS PROGRAM

Enacted in 2004, Code Section 409A and its subsequently issued interpretative regulations establish a detailed and complex framework governing the timing and form of nonqualified deferred compensation payments. Operational and documentary violations of the rules may result in severe tax penalties on executives and other service providers.[4] After an extended transition period that was subject to less stringent legal standards and compliance requirements, Code Section 409A became fully effective beginning after December 31, 2008.[5] As a result, beginning in 2009, compliance with the rules has become far more difficult than in previous years, with greater risks of operational and documentary violations.

On December 5, 2008, in Notice 2008-113 (the "Notice"), the IRS published a voluntary program that permits employers to correct certain Code Section 409A operational failures with no or reduced tax penalties. Participation in the program is subject to numerous requirements, including whether the failure was inadvertent and unintentional, whether the employer has experienced significant financial difficulties, and disclosure to the IRS. Applicable penalties vary depending on whether the service provider is considered an insider[6] and on whether the correction is made in the same taxable year in which the failure occurs, the immediately following taxable year, or the second following taxable year. As would be expected, the later the correction is made, the greater the tax penalties. Numerous special rules apply covering corrections to stock option exercise prices, so-called "limited amounts," and other matters. Corrective actions must therefore be taken under the Notice no later than the last day of each calendar year in order to qualify under the corrections rules applicable to failures occurring in that calendar year, as well as in the two preceding calendar years.

Of unique importance for the 2009 calendar year, the Notice provides one-time transition relief for non-insiders. Under this transition relief, 2009 will be treated as the immediately following taxable year for correction of operational failures occurring prior to 2008, which should result in less severe tax penalties. In addition, companies should be cognizant that certain general income tax principles may provide opportunities to make same-year corrections to Code Section 409A violations without relying on the Notice for relief. Finally, Code Section 409A regulations occasionally provide relief from certain apparent operational failures. For example, a payment made up to 30 days prior to the scheduled due date may not be treated as a violation of Code Section 409A.

4 "Operational" violations include failure of a company to comply with the terms of a plan, such as an acceleration or deferral of compensation payments that fails to comply with the controlling plan documents. "Documentary" failures include (i) a plan provision that violates applicable Code Section 409A requirements and (ii) the omission of a plan provision required by Code Section 409A.

5 See our October 2007 *Jones Day Commentary*, "Section 409A Respite: IRS Grants One-Year Delay," *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4686.

6 An "insider" is defined in the Notice as a director, officer, or greater than 10 percent equity owner, as determined in accordance with SEC rules under section 16 of the Securities Exchange Act of 1934, as amended. Analogous standards are applied to private companies and noncorporate entities.

For these reasons, companies may want to consider prompt implementation during the balance of 2009 of a targeted Code Section 409A compliance review in order to have sufficient time to identify correctable operational failures and to consider whether participation in the Section 409A corrections program would be available and advisable.[7] If the scope of such review is not practical for all employees and other service providers with deferred compensation, then the review should focus on insiders, since the Notice treats insiders much less favorably after the year in which the Code Section 409A violation has occurred.

7 IRS Information Document Requests that have been issued in the tax audit process to companies to identify potential Code Section 409A violations may serve as a useful internal audit guide.

LAWYER CONTACTS

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

John R. Cornell
New York
1.212.326.8332
jrcornell@jonesday.com

Dennis B. Drapkin
Dallas
1.214.969.4850
dbdrapkin@jonesday.com

Daniel C. Hagen
Cleveland
1.216.586.7159
dchagen@jonesday.com

Rory D. Lyons
Atlanta
1.404.581.8550
rlyons@jonesday.com

Manan D. Shah
New York
1.212.326.3986
mdshah@jonesday.com

Charmaine L. Slack
New York
1.212.326.8381
cslack@jonesday.com

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