October 27, 2005

Memorandum for: Interested Persons

Re: Deferred Compensation Rules - Section 409A of the Tax Code

On September 29, 2005, the Treasury Department and the IRS issued proposed regulations interpreting the deferred compensation rules under Section 409A of the Internal Revenue Code, which were part of the American Jobs Creation Act of 2004 enacted in October of 2004. The proposed regulations expand on the guidance provided by the Treasury Department and the IRS under Notice 2005-1 released on January 10, 2005.

Section 409A establishes detailed rules for the operation of all nonqualified deferred compensation plans (“NQDC Plans”), a term which is broadly defined to include any arrangement that provides for compensation earned in one tax year to be paid in a future tax year. Section 409A applies to classic deferred compensation arrangements and many types of bonus, severance and long-term incentive programs, although the rules exempt qualified pension and savings plans, Section 457 plans and most welfare benefit plans.

This memorandum provides an overview of Section 409A and the proposed regulations and how they affect a variety of typical compensation arrangements. The memo is divided into the following topic areas:

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Transition Rules and Steps to Take

Beginning January 1, 2005, all NQDC Plans were required to comply with Section 409A. Amounts that were earned, vested and subject to a deferral before January 1, 2005 are “grandfathered” and exempt from Section 409A, provided that the arrangements pertaining to those amounts have not been materially modified after October 3, 2004.

NQDC Plans must be in documentary compliance with Section 409A by December 31, 2006, and until then all NQDC Plans must be operated in good faith compliance with Section 409A. A NQDC Plan will be deemed to comply with Section 409A if it is operated in good faith compliance with the rules established under Notice 2005-1 or the proposed regulations. A taxpayer may generally rely on either Notice 2005-1 or the proposed regulations until the proposed regulations become final. However, where the proposed regulations address a topic not addressed in Notice 2005-1, taxpayers should comply with the proposed regulations. The proposed regulations are scheduled to become final as of January 1, 2007, at which time Notice 2005-1 will cease effect.

Steps to Take. Below is an outline of steps that may be taken to avoid running afoul of Section 409A and to take advantage of the transition relief provided under Notice 2005-1 and the proposed regulations.

Prior to December 31, 2005. The transition rules under Notice 2005-1 and the proposed regulations offer latitude to make certain changes in 2005:

Election Changes – Prior to December 31, 2005, employees may be permitted to change their elections relating to any previously deferred compensation. An employee may elect to cancel a deferral election and receive the deferred amounts prior to December 31, 2005, or change a previously designated date or form of payment. Any change in 2005 to a previously designated date or form of payment (other than an election to terminate the deferral and receive payment in 2005) will bring the amounts deferred under the new Section 409A rules, even if they were previously grandfathered. Thus, parties should consider any changes carefully and should structure any new election as to time and form of payment to comply with the initial election rules of Section 409A, which are described below.

A participant will also be permitted to cancel or amend an existing deferral election in 2006, but the participant may not defer a payment in 2006 that would otherwise be payable in 2006 or accelerate a payment to 2006 that would otherwise be paid after 2006; such a change would need to be made before December 31, 2005.

Discounted Options and SARs – Under the Section 409A rules, discounted stock options and discounted stock appreciation rights are treated as noncompliant deferred compensation arrangements. To the extent that a previously granted discounted stock option or discounted stock appreciation right had not become fully vested prior to the January 1, 2005 effective date of Section 409A, the unvested portion will violate Section 409A. However, the transition rules permit the holder and the issuer of such a discounted award to take action before December 31, 2005 to ameliorate the problem. The holder may exercise the award or the issuer may re-price...
the award to the fair market value strike price prevailing at the time of the original grant and pay
the holder the difference in cash, provided that these actions are taken before December 31,
2005.

Plan Terminations – If an employer wishes to terminate an existing deferred
compensation plan, it may do so prior to December 31, 2005. Termination of a deferred
compensation plan after the end of this year will be subject to more restrictive rules, which are
summarized below.

Reversal of Modifications – If an employer or employee has already made a material
modification to what otherwise would have been a “grandfathered” deferred compensation
arrangement, thereby causing the deferred compensation arrangement to be subject to Section
409A, the parties may revoke the modification before the end of 2005 and regain
“grandfathered” status.

Suggestions for Employers Over the Near Term. Since the proposed regulations give
employers until December 31, 2006 to bring their plan documents into compliance with Section
409A, employers should take time to carefully review their plans and consider the changes they
may need or wish to make. Steps an employer could take might include the following:

Plan Review – Review all compensatory arrangements in order to identify those that are
subject to Section 409A. As noted, arrangements such as employment agreements, bonus,
severance and long-term incentive plans may include provisions subject to Section 409A.

Devise Rules for Compliant Plan Administration – Although plans need not comply in
form with Section 409A until December 31, 2006, they must operate in good faith compliance
with Section 409A immediately. Therefore, as part of the exercise of reviewing all plans, an
employer might draft a short tickler list for each plan setting forth any Section 409A operational
rules and pitfalls that apply to the plan so that those who make awards under the plan or
administer the plan will not make inadvertent errors.

Determine Whether Any Existing Plans Should Be Bifurcated – As noted, deferred
amounts that were earned and vested prior to the January 1, 2005 effective date of Section 409A
are not subject to the Section 409A rules unless the arrangements relating to these amounts have
been materially modified after the October 3, 2004. Thus, employers and employees will want to
be careful not to inadvertently modify arrangements relating to these grandfathered amounts.
This might be accomplished either by adding a clause to any plan that covers grandfathered
arrangements making clear that any plan modification will not apply to grandfathered amounts
unless explicitly provided or by freezing a grandfathered plan and creating a new plan to cover
post-effective date deferred compensation.

Public companies and their executive officers should be mindful that significant changes
and actions with respect to plans and arrangements covering executive officers may trigger a
Form 8-K disclosure duty and, in some cases, may affect reporting under Section 16 of the
Exchange Act. Therefore, companies will obviously want to coordinate their changes across all
NQDC Plans to avoid multiple and confusing disclosures. In addition, employers should

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consider the accounting effects of any changes, particularly changes that affect stock-related awards.

**Summary of Section 409A Rules**

*Nonqualified Deferred Compensation.* Section 409A generally applies to all nonqualified deferred compensation, which includes most types of compensation earned in one tax year but payable in a future tax year. Section 409A applies to compensation payable to any service provider, a term which includes employees, independent contractors (including directors), service partners and even service entities. This memorandum principally discusses the application of Section 409A to employees. Since the rules applicable to employees and directors are largely similar, rules described as applying to employees can generally be assumed to apply equally to directors.

The rules under Section 409A place emphasis on the date an employee obtains a “legally binding right” to compensation. An employee will have a legally binding right to a compensatory award even if the vesting and payment of the award is subject to stated future conditions, such as continued employment or attainment of performance goals. In essence, an employee will only fail to have a legally binding right to an award if the employer has unfettered discretion to decide not to pay the award (e.g., a completely discretionary incentive award).

Unless an exception applies, the deferral election rules of Section 409A must be followed in any case where an employee is given a legally binding right to compensation that will not be paid until a subsequent tax year. Although the discussion in this memo refers to employee elections relating to the time and form of payment of deferred amounts, Section 409A applies to both elective and non-elective NQDC Plans and generally treats the time and form of payment provided under a non-elective NQDC Plan as if it were an election by each participating employee.

*Initial Deferral Elections.* The date by which an initial election to defer compensation must be made will depend on the circumstances, as follows:

**General** – Unless one of the exceptions below applies, an employee’s election to defer compensation earned during a particular year must be made and become irrevocable by December 31 of the prior year. This rule applies, for example, to deferrals of base salary.

**Forfeitable Awards** – Under a so-called “ad hoc award exception,” if an employee is granted an award which is not subject to vesting or payment based on performance criteria, but is conditioned on the employee’s continued employment for a period of at least 1 year (e.g., restricted stock units), the employee may make an election to defer payment of the award beyond its vesting date, provided that the election is made within 30 days after the award is granted and at least 1 year before the first vesting date under the award.

**Performance-Based Compensation** – If an award or an amount qualifies as “performance-based compensation”, and the applicable performance measurement period is at least 1 year, an initial election to defer receipt of the award or amounts may be made at any time up until the

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date six months prior to the end of the performance period, provided that the election is made before the award or amount that will be received becomes both substantially certain and readily ascertainable. Generally speaking, performance-based compensation is compensation the amount of or entitlement to which is contingent on the satisfaction of pre-established organizational or individual performance criteria measured over a period of at least 1 year.

First Year of Eligibility – Under a limited exception, an employee who first becomes eligible to participate in a particular type of plan after the standard date for deferral election has passed will nevertheless be permitted to submit a deferral election within 30 days of first becoming eligible, although this initial election may only apply amounts earned for services after the date of the election.

Separation Pay – If, pursuant to a bona fide arm’s-length negotiation, an employee receives a legally binding right to separation benefits payable on an involuntary separation from service, the employee may make an initial election to defer the separation benefits at or before the time the employee obtains the legally binding right to the separation benefits. This and other special rules relating to separation benefits are discussed later in this memo.

Permitted Payment Events.

Election as to Time and Form of Payment. An election to defer the payment of compensation must state the time and form of payment (e.g., lump sum or stated installment/annuity plan). The medium of payment (e.g., cash or stock) may be fixed at any time, except that a medium which involves an additional deferral feature, such as restricted stock units, must be analyzed under the Section 409A rules. With respect to the time of payment, the rules offer six permitted payment events:

- a specified date
- separation from service
- disability
- death
- change in control
- unforeseeable emergency

The rules provide fairly intricate definitions and conditions applicable to payments made in the event of a separation from service, disability, change in control or unforeseeable emergency.

Generally, an employee election may provide for payment on a permitted payment event or on an objectively determinable date following the permitted payment event (e.g., the first anniversary of the permitted payment event). An election may provide for payment upon the earliest of two or more permitted events and may prescribe different forms of payment depending on the event (e.g., installments commencing on a separation from service or specified date, but a lump sum in the event of disability or death). An election may also provide for accelerated payments upon the occurrence of a second permitted event (e.g., the election may provide that installments being paid after a termination of employment be accelerated to a lump sum in the event of death).

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Limited Exception for Delayed Payments. Recognizing that there may be administrative delays in the payment of deferred amounts under some circumstances, the rules provide that amounts scheduled to be paid on a permitted payment event may be paid after the event, provided that they are paid by the end of the employee’s tax year in which the event occurs. In limited circumstances the rules permit the payment to be made in the tax year following the year in which the permitted payment event occurs (but within 2½ months after the date of the event), provided that it was impracticable to determine and pay the amounts by the end of the earlier tax year.

Six Month Waiting Period. All “specified employees” of a public company must wait until six months after the date of separation from service to receive any deferred compensation payable on a separation from service. Specified employees include: (i) the 50 top-paid officers of the employer having annual compensation greater than $135,000 (subject to COLA adjustment); (ii) a 5% owner of the employer; and (iii) a 1% owner of the employer having annual compensation greater than $150,000. To ease compliance with this rule, the Section 409A rules permit a corporation to determine its key employees as of a date chosen by the corporation, with effect for the 1-year period beginning as of the start of the fourth month following the determination date. For example, a corporation may determine its key employee group based on the 12 month period ending each December 31 and have that determination apply for the 1-year period beginning as of the next April 1.

Changes to Payment Elections. Deferral elections may only be changed under limited conditions.

Acceleration of Payment – Deferred compensation may only be accelerated and paid prior to the permitted payment events initially elected under limited exceptions prescribed by the rules, which include:

- payment of small balances in connection with an employment termination,
- payment in connection with a domestic relations order,
- payments to cover currently payable FICA and employment taxes that arise when an amount becomes vested under a plan,
- acceleration from installment to lump sum in accordance with a valid subsequent deferral election described below, or
- payments in connection with a plan termination meeting the conditions described below.

The previously accepted practice of permitting employees to elect to receive deferred amounts early pursuant to a 10% “hair cut” is not permitted for amounts subject to the new Section 409A rules.
Redeferrals – Generally, the payment of a deferred amount may only be re-deferred beyond the tax year of the initial payment event if the subsequent deferral election is made at least 1 year prior to the first payment date under the initial payment event and payment is deferred until at least 5 years after the initial payment event. For example, if an employee has initially elected annual installment payments beginning at age 60, the employee’s election to delay payment must be made prior to age 59 and must postpone the commencement of installment payments until age 65 or later. Again, the rules offer limited exceptions where these rigid redeferral rules do not need to be followed, such as the delay of payments to an executive officer in order to avoid non-deductibility under the $1 million limit of Code Section 162(m).

Short-Term Deferral Exception. Under a short-term deferral exception provided under the Section 409A rules, no deferral of compensation will be deemed to have taken place if the amounts are paid by the later of 2 1/2 months after the end of the tax year of the employee in which the amounts are no longer subject to substantial risk of forfeiture or 2 1/2 months after the end of the tax year of the employer in which the amounts are no longer subject to substantial risk of forfeiture.

In order to qualify for the short-term deferral exception, the plan or arrangement does not necessarily have to state that the award must be paid within the 2 1/2-month period, but there are advantages under the rules to doing so. For example, the terms of a bonus plan could provide that bonuses will be paid on March 15 of the year following the performance year. If the bonuses were paid after March 15, they would not be eligible for the short-term deferral exception. However, by having a specified date of payment, the bonuses would qualify as deferred compensation subject to a payment on a specified date election and would enjoy the benefit of the rule described earlier which permits amounts payable on a specified date to be paid anytime after the specified payment date and in the same year (i.e., the amounts would be treated as deferred compensation which satisfies the requirements of Section 409A).

Limitation on Plan Terminations. After the transition period ending December 31, 2005, a NQDC Plan may only be terminated if the plan termination is approved by a bankruptcy court or is in connection with a liquidation of the plan sponsor, or:

- a plan termination in which --
  - all similar plans of the employer are simultaneously terminated,
  - the amounts under the terminated plans are paid within 2 years of the termination of the plans but not before the expiration of 1 year after the termination of the plans, and
  - a similar plan is not implemented within 5 years following the plan termination, or
- the plan termination is in connection with a change in control and --
occurs during the period commencing 30 days before and ending 1 year after
the change in control,

- entails a termination of all similar plans of the target company, and
- requires the payment of all plan amounts within 1 year of the plan
termination.

**Effect of Noncompliance.** If the amounts payable to an employee under a NQDC Plan fail to comply with the requirements of 409A, then those amounts, and all amounts payable to the employee under any similar NQDC Plan, will cease to be entitled to deferral and will be subject to an additional 20% federal tax, over and above the applicable income tax.

For an employer, noncompliance with the rules of Section 409A does not entail any direct tax or penalty, but it will affect the timing of the employer’s deduction for the affected amounts, and if the employer has not withheld the proper amounts in respect of the taxes owed by the employee, the employer may be subject to penalties and exposed to liability if the employee fails to pay the applicable taxes.

**Traditional Elective Deferral Plans**

**Elective Salary Deferrals.** Any arrangement permitting elective deferral of base salary into a year later than the year in which the salary is earned is a NQDC Plan and must comply in form and operation with the rules of Section 409A. The plan must require that a participant’s initial election to defer salary earned in any tax year of the employee be submitted and become irrevocable no later than the close of the employee’s prior tax year. As noted, if an employee first becomes eligible in mid-year to participate in a salary deferral plan (i.e., the employee is hired or promoted into a covered position), the employee may submit a deferral election within 30 days after becoming eligible and the election may apply to salary earned for services after the date of the election. Standing deferral elections applicable year-to-year are permitted.

**Deferral of Bonus and Cash LTIP Payments.**

**Awards Not Deferred.** Pursuant to the short-term deferral exception, most annual bonus incentives and long-term cash incentives would not be treated as deferred compensation as long as the payment of these incentives is subject to a substantial risk of forfeiture until the close of the applicable performance period, and the incentives are paid by the short-term deferral deadline described above.

**Awards That Are Deferred.** If payment of an annual bonus or LTIP award is intended to be deferred beyond the short-term deferral period, the date by which an initial deferral election must be made will depend upon the terms of the bonus or award, as follows.

**Deferral of Performance-Based Incentives.** If, as described earlier, incentive payments qualify as performance-based compensation, and the applicable performance measurement period is at least 1 year, an initial election to defer receipt of those payments may be made at any
time up until the date 6 months prior to the end of the performance period, provided that the election is made before the incentive amount becomes both substantially certain and readily ascertainable.

**Deferral of Discretionary Incentives.** If the payment of a bonus or cash LTIP is not strictly keyed to pre-determined performance criteria, but is instead discretionary, the arrangement might not confer a legally binding right on the employee until the employer determines and declares the payment amount. An award will be discretionary if the employer has an unconditional, unilateral right to reduce or eliminate the award and this right has substantive significance in the given context. If under the facts and circumstances an employee does not have a legally binding right to payment of an award until it is actually determined and paid, the employee may make an initial election to defer payment at any time prior to the end of the employee’s tax year preceding the year of payment.

**Deferral of Fixed Bonuses.** Finally, if a bonus or cash LTIP is neither performance-based nor discretionary but instead is fixed and payable subject only to the employee’s continued employment through the end of a stated period, an initial election to defer payment must be made by the end of the employee’s tax year preceding the date the bonus or award is granted or communicated (i.e., the date it becomes a legally binding promise). Alternatively, the election can be made at any time within 30 days after the bonus or award is granted in accordance with the ad hoc award exception described earlier.

**Stock Options and SARs**

**Exemption.** Under an exception provided by the Section 409A rules, a stock option or stock appreciation right (SAR) will not be subject to Section 409A, provided that:

- the underlying security is “service recipient” common stock with no preferred stock features,
- the exercise price of the award is not, and cannot be, less than the fair market value of the covered stock as of the award grant date,
- the award is not impermissibly modified or extended after the grant date,
- the number of shares underlying the award is fixed at the grant date, and
- the award has no other deferral of compensation feature.

**Prior Noncompliant Grants.** Noncompliant options or SARs that were vested as of December 31, 2004, are exempt from Section 409A. However, noncompliant options or SARs that were not vested as of December 31, 2004 are subject to the Section 409A and will be treated as violating Section 409A. These noncompliant awards may be replaced with compliant awards through December 31, 2006. For example, an unvested discounted option granted on September 30, 2004 may be replaced not later than December 31, 2006, with a new option with an exercise price not less than the fair market value of the underlying security on September 30,
2004. As described earlier, however, if an employer wishes to compensate an award holder with a cash payment equal to the foregone discount it must act before December 31, 2005.

Compliant Grants. Options and SARs will only be entitled to the exemption above if they relate to “service recipient” common stock. In situations involving an affiliated group of entities, the Section 409A rules contain detailed provisions for determining the entity whose stock may be the subject of option or SAR awards to employees under the exemption. In an affiliated group with a single public parent, options and SARs must generally relate to the stock of the public parent in order to qualify for the exemption. Under this rule, non-U.S. companies whose stock is listed on an established trading market outside the U.S. may be precluded from granting awards that relate to equity of a U.S. subsidiary. Special rules are provided for situations involving private company groups and joint ventures.

As noted, compliant options and SARs must include an exercise price that will never be less than the fair market value of the underlying common stock and a fixed number of shares as of the grant date. The rules provide guidance for determining the fair market value of private company stock. Although equitable adjustments to awards in connection with certain corporate transactions are permitted, the rules are fairly rigid in other respects. For example, a right to receive upon exercise dividends previously paid on the underlying common stock will be deemed an improper discount to the exercise price, unless the right is a separate arrangement payable on a permitted payment event and otherwise complies with Section 409A. Compliant awards may be settled in cash or stock, but the stock must be “service recipient common stock.” Options that qualify as incentive stock options under Code Section 422 or are granted under a Code Section 423 employee stock purchase plan are exempt from Section 409A.

Modifications. Certain changes or “modifications” to outstanding stock options or SARs will be considered a new grant and could therefore be treated as the grant of a discounted option or SAR, thus failing the grant date fair market value requirement. Modifications that would result in adverse treatment under Section 409A include, but are not limited to:

- direct or indirect reduction in the award’s exercise price (for example, adding impermissible dividend rights to an award), and
- extension of the award’s exercise period, other than an extension which does not lengthen the exercise period beyond the later of December 31 of the year in which the right would otherwise have expired or 2½ months after the date the right would have expired.

Certain changes will not be considered “modifications” and will not disqualify compliant Section 409A awards, such as:

- accelerated vesting,
- shortening the award term,

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• permitting payment of the exercise price by tender of previously acquired shares,
• issuer retention of shares to satisfy withholding obligations, and
• issuer facilitation of otherwise permissible award transfers.

Substitution or adjustment in connection with a corporate transaction (e.g., merger or spin-off) is permitted so long as aggregate spread values and ratios are maintained.

Full Value Stock Awards

Restricted Stock. A deferral of compensation does not occur under Section 409A merely because an employee receives property the value of which is not includible in income in the year of receipt. In other words, restricted stock – whether it vests over time or as a result of performance, or both – does not constitute deferred compensation.

RSUs and DSUs. An arrangement whereby the employee obtains a legally binding right (whether or not the right is vested at the time of grant) to receive property in a future year may constitute deferred compensation. Thus, a restricted stock unit (RSU) or deferred stock unit (DSU) will generally need to be settled upon vesting in accordance with the short-term deferral exception described earlier or on one or more permitted payment events fixed at the time of grant.

Dividends or dividend equivalents that accrue with respect to an award of restricted stock or RSUs, but are not paid out until a future time, may constitute deferred compensation. However, if the payout is only deferred to when the underlying award is no longer subject to a substantial risk of forfeiture (which is the case with many accrued dividends and dividend equivalents), it will comply with the short-term deferral exception.

Deferred Payment of RSUs. If an award of RSUs vests over time, and the employee wants to defer the settlement date, he or she has a few options: (1) prior to receipt of the award, arrange to defer the settlement date to one or more permissible payment events (which might be feasible if the award is part of an annual granting program); (2) if the award is subject to a substantial risk of forfeiture requiring employment for at least 1 year, then, within 30 days of grant and at least 1 year before the vesting date, defer the settlement to one or more permissible payment events; or (3) at least 1 year before the original settlement date, defer the settlement to one or more permissible payment dates occurring at least 5 years after the original settlement date (i.e., comply with the subsequent deferral rules).

In the case of an award of RSUs that vests based on the satisfaction of pre-established organizational or individual criteria relating to a performance period of at least 1 year (i.e., the RSU qualifies as “performance-based compensation”), the election to defer the settlement date can be made as late as 6 months prior to the end of the performance period, but not after the amount under the award has become substantially certain to be paid and readily ascertaintable.
A number of private companies have granted RSUs that vest over time or based on performance (or DSUs, which by their terms are already vested) and then settle upon a “liquidity event,” as defined in the relevant plan. A liquidity event may qualify as a permissible payment event if the liquidity event happens to fit within the definition of "change in control" applicable under Section 409A, but, as discussed below, that definition is somewhat narrow and would not include certain common liquidity events such as an IPO.

SERPs and Excess Plans

Coverage of Section 409A. Supplemental retirement plans, whether or not they have any elective deferral features, will generally be covered by Section 409A as they provide for payment well after the benefit has vested. The primary aspect of the new Section 409A rules that will affect these supplemental plans is the subsequent election rules discussed earlier. Plan sponsors will have some flexibility in designating whether all payments from a NQDC Plan will be treated as one payment or a series of payments for purposes of these rules. For example, if “annual installments payable July 1 over 15 years” is treated as one payment, then assuming the election is made at least 1 year prior to the date of the first installment, the participant could elect to receive a lump sum payment 5 years after the first scheduled installment date rather than 5 years after the 15th scheduled installment date. Generally, the employer’s choice on this rule should be reflected in the plan document, but a life annuity is always treated as a single payment and a series of installments will be treated as a single payment unless the arrangement provides otherwise.

Coordination with Qualified Plans. Under Section 409A it will generally be possible for NQDC Plans to be coordinated with underlying qualified plans, although some special rules exist for so-called “401(k) wrap” programs. Plan sponsors and employees have until December 31, 2006 to amend existing arrangements to link the timing and form of payments under a NQDC Plan to elections made for the related qualified plan, although the Section 409A rules caution that the general constructive receipt rules under the Code continue to apply to the operation of a NQDC Plan.

Additional Transition Issues. Because the deadline for amending plan documents has been extended until December 31, 2006, employers with plans that have significant benefits that were earned and vested as of December 31, 2004 (and therefore are not covered by Section 409A unless the plan is materially modified in respect of those benefits) now have more time to determine whether it is a better practice to create a separate plan document for benefits subject to Section 409A or continue to provide pre- and post-Section 409A benefits under the same plan document.

Severance Arrangements

Limited Exemptions. Unless subject to a specific exemption, separation pay plans are generally covered by Section 409A. However, the Section 409A rules exempt from coverage separation payments that are: (1) payable upon an actual involuntary termination of employment or under a “window program,” (2) not more than the lesser of two times the employee’s annual compensation or the maximum amount that may be taken into account for qualified plan.

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purposes ($210,000 in 2005), and (3) paid no later than the end of the second calendar year following the year in which the separation from service occurs. Separation pay arrangements that meet these conditions will be exempt from the ordinary election and payment rules of Section 409A and will be exempt from the 6-month post-employment waiting period applicable to NQDC Plan payments to a public company key employee. Treasury Department officials have informally suggested that plans intended to qualify for this exemption be drafted as stand-alone plans.

Also exempt from Section 409A are outplacement, relocation, medical or in-kind benefits provided as part of a severance arrangement, provided that these expenses are incurred and reimbursed by the end of the second calendar year following the year in which separation from service occurs. In addition, other benefits that do not exceed $5,000 in the aggregate will be exempt.

\textit{Short-Term Deferral; “Good Reason” Termination.} Payments due upon an involuntary termination may be characterized as being subject to a substantial risk of forfeiture. As such, if they are paid within the “short-term deferral” period, they will be exempt from Section 409A. The result of this is that many involuntary severance arrangements can be drafted to fall outside the scope of Section 409A. Citing the potential for abuse, however, the preamble to the proposed regulations makes it clear that payments upon a resignation for “good reason” are not categorically treated as subject to a substantial risk of forfeiture. The Treasury Department and IRS have requested comments on this topic. Until further guidance is received, all severance payments under any arrangement with “good reason” resignation provisions should be structured to comply with Section 409A (which may involve a 6-month delay of payment for public company key employees, as described earlier).

\textit{Negotiated Agreements.} Where a separation arrangement provides for benefits that do not fit into the exemptions and exceptions above, the arrangement must comply with Section 409A. If an employee is entitled to severance as the result of a bona fide, arm’s-length negotiation, then the employee will be permitted to make an election as to the time and form of payment on or before the date the employee obtains a legally binding right to the amounts due (e.g., prior to or upon execution of the agreement).

\textit{Near-Term Actions.} Publicly traded companies should consider amending individual employment and severance agreements to provide for the possibility of a 6-month waiting period for key employees and all companies should consider amending broad-based severance plans to comply with the exemptions described above. In addition, it may be an appropriate time to examine existing definitions of “good reason” and “constructive termination” in such arrangements.

\textbf{Investment Manager Plans}

\textit{Partnership Profits Interests.} Until further guidance is issued, a service provider to a partnership who is granted an actual profits interest in the partnership may generally treat the issuance of the interest and the amounts realized from the interest as exempt from Section 409A,
provided that the interest is a true profits interest and does not entail payments considered “guaranteed payments” under the partnership rules of the Code.

Notional Carry and Incentive Fee Point Pools. Plans pursuant to which participants are given an interest or points in a notional pool based on the fees or profits generated by certain investment funds or accounts can raise issues under Section 409A. Because amounts payments under these plans are typically payable to participants upon the occurrence of future events, such as the realization of the amounts by the general partner or asset manager, the amounts might be viewed as deferred compensation which fails to satisfy the permitted payment event rules of Section 409A. Depending on the facts, a plan of this sort could conceivably fit within the short-term deferral exception, provided that payments are made to the participants as soon as the underlying fees are realized. Alternatively, these plans can be designed to comply with the Section 409A rules by providing that payments will be made to participants on a fixed schedule.

Back-to-Back Arrangements. The Section 409A rules permit back-to-back arrangements under which a management entity that is entitled to receive a management or incentive fee from an investment fund defers payment of the fee based on corresponding deferral elections made by the partners or employees of the management entity. The rules under Section 409A provide that if the election made by the partners and employees of the management entity are made in accordance with Section 409A, the related election by the management entity made in accordance with Section 409A may provide that the deferred fees be paid by the fund as and when such fees become payable under the elections of the participating partners and employees.

Changes in Control

General. Amounts under a NQDC Plan may be subject to payment on a change in control (CIC) if a CIC payment acceleration was included in the applicable initial payment election or in a valid subsequent deferral election. NQDC Plan amounts payable to a key employee of a public company based on a post-CIC separation from service (i.e., double-trigger arrangements) will presumably be subject to the 6-month payment delay rule described earlier. Therefore, employers should be mindful of the 6-month rule in reviewing their plans in the short-term and in interpreting them in the event of a CIC.

With respect to an employee, a CIC includes: (i) a CIC of the employee’s employer, (ii) a CIC of an entity responsible for payment of the deferred compensation owed to the employee or (iii) a CIC of a direct or indirect parent company of an entity described in (i) or (ii). The rules relating to CICs are rather complex, but, in essence, a CIC of a corporation will be deemed to occur upon:

- a change in ownership as a result of the acquisition of more than 50% of the total fair market value or total voting power of the stock of the corporation by any person or group of persons acting together,

- a change of effective control as a result of (i) the acquisition of 35% or more of the total voting power of the stock of the corporation by a person or group of persons acting together or (ii) the replacement of a majority of the members the
corporation’s board of directors within a 12-month period by directors who are not endorsed by the corporation’s board, or

- an acquisition of 40% of the total fair market value of the assets of the corporation within a 12-month period by a person or group of persons acting together.

The definition of CIC for purposes of Section 409A is based on the definition under Section 280G of the Code, but there are a number of important differences. The triggering percentages noted above for a change in effective control and an acquisition of assets are higher under Section 409A than the percentages used under Section 280G. In addition, in the case of an affiliated group of companies, the CIC definition under Section 280G is triggered only by a change which affects the entire affiliated group, while the Section 409A definition allows a NQDC Plan to use a CIC trigger based on a CIC of an employee’s employer or an entity responsible for the payment of the employee’s deferred compensation. Finally, although Section 280G does not apply to a CIC of a partnership, the Treasury and IRS have stated that a change in ownership of a partnership or a sale of a substantial portion of the assets of a partnership may be treated as a CIC under Section 409A. The Treasury and IRS expect to issue guidance on CICs affecting partnerships, but in the meantime they have suggested that the Section 409A CIC definition for corporations be applied by analogy.

Treatement of Section 409A Exempt Options and SARs. As described, grandfathered pre-Section 409A stock options and SARs and post-Section 409A options and SARs granted at a market value strike price are exempt from Section 409A. Generally speaking, the typical approaches to dealing with these options and SARs in a CIC will continue to be permissible under Section 409A. Nothing in Section 409A would prevent these awards from being accelerated in connection with a CIC. A cash-out of these awards in a CIC would be treated as an exercise and would result in an ordinary income event for the holder, but would not attract an additional 20% tax under Section 409A, regardless of whether the cash-out was effected pursuant to pre-established terms of the award or the terms of the CIC transaction. Alternatively, a Section 409A exempt option or SAR may be rolled over into a similar right on the acquiror’s stock without jeopardizing the exemption from Section 409A, provided that the rollover is done in a manner which does not increase the aggregate spread or the ratio of exercise price to market price under the award.

Accelerated Bonus and Cash LTIP Awards. Bonus or cash LTIP awards may be accelerated and paid at any amount or level upon a change in control without implication under Section 409A, provided that the amounts are paid by the short-term deferral deadline described earlier.

Amounts Covered by Section 409A. For other amounts and awards that are treated as nonqualified deferred compensation under Section 409A (e.g., elective salary/bonus deferrals, RSUs, SERPs), the rules under 409A do not prevent accelerated vesting of those amounts upon a CIC and the rules permit the payment/settlement of those amounts on a CIC, provided a CIC payment trigger was properly included in the applicable payment election or in the plan terms. If a pre-established CIC payment/settlement trigger does not exist, the amounts may generally not

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be paid or settled on a CIC, unless the relevant NQDC Plans are terminated in connection with the CIC, as described earlier.

_Funding of NQDC Plans._ Under Section 409A, amounts under a NQDC Plan will be included in the income of plan participants immediately if the amounts are funded through an offshore trust or if, in connection with a change in the employer’s financial health, the amounts are funded through an arrangement insulated from the claims of the employer’s creditors.

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This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. To ensure compliance with requirements imposed by the IRS, we inform you that the discussion of U.S. federal tax issues contained in this memorandum is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

If you have questions about Section 409A, please feel free to call your Davis Polk contact.