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B&B REVIEW

Corporate and Securities

New IRS Regulations on Taxation of Deferred Compensation Require Review of Executive Employment and Change in Control Agreements

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INTRODUCTION

Congress's distaste for executive compensation was shown last year when as part of the Jobs Creation Act of 2004 it imposed significant restrictions on deferred compensation in a new Section 409A of the Internal Revenue Code. Congress believed that in too many deferred compensation arrangements, there was really no "substantial risk of forfeiture" to the employee, and that such arrangements were being used by executives to "time" their receipt of income that they otherwise would be able to collect immediately.

The Internal Revenue Service provided "Q&A" guidance on the new law within just a few months of its passage, and on September 29, 2005 issued proposed regulations.

Section 409A and the regulations impose a number of requirements that "deferred compensation arrangements" must satisfy in order to avoid current taxation of an employee. Such taxation can impose quite a burden because the payments (if not the taxation) are in fact deferred, and the employee would be required very quickly to find the cash to pay the tax (and a 20% "additional tax" and interest charges) on the full amount deferred.

The new law and regulations can have far-reaching effects on a variety of compensation arrangements. However, one area of particular scrutiny for companies of all sizes, whether publicly-held or private, should be the employment or change in control agreements with executives that might constitute deferred compensation as defined by the IRS. Changes in these agreements if made before events such as a separation from service or a change in control could help avoid unnecessary tax burdens on the executives. The recent regulations make clear that both voluntary and involuntary separation payments are subject to Section 409A to the extent payments involve a deferral of compensation.

SEVERANCE PAYMENTS AFTER INVOLUNTARY TERMINATIONS – PAYMENT TERMS NEGOTIATED IN ADVANCE

Many executives have individual arrangements in place that pay out only upon an involuntary separation from service. Sometimes, these arrangements are built in to agreements that are primarily designed to provide for payments upon a change in control (see discussion below). An "evergreen" employment agreement that would provide for salary continuation following an involuntary termination would also constitute such an arrangement. If under any of such arrangements severance payments following an involuntary termination are not structured in accordance with Section 409A and the new regulations, they will be deemed to be "deferred compensation" that is subject to the new law.

Short-Term Deferrals.

The proposed regulations permit involuntary severance payments made pursuant to an existing contract to be made without triggering Section 409A if they are made within 2-1/2 months following the end of either the employee's or the employer's tax year during which the termination of employment occurred, under the exception for short-term deferrals. The new regulations do not require that the employee's contract contain this deadline so long as the deadline is actually observed. However, if the payment is not made by the deadline, then there is an automatic violation of

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Section 409A. By contrast, if the contract contains the deadline provision, then a failure to meet the deadline may be excused if the payment is at least made in the same calendar year as the deadline date.

It should also be noted that the 2-1/2 month deadline date can itself be deferred (i.e., the payment date may be later than the short term deferral deadline date), but only if the deferral was made at least a year in advance of the termination date and if the payment is deferred to a date which is at least five years after the termination date. This would appear to be a difficult election to make in the somewhat hypothetical context of an involuntary termination of employment.

Exemption Based on Dollar Amount Paid

Beyond the availability of the short term deferral exception described above, the IRS rejected requests to exempt generally from Section 409A severance payments after an involuntary termination. However, The IRS has provided a further limited exemption if the amount of the payment does not exceed two times the lesser of (i) the employee's annual compensation or (ii) the limitation in effect under the Internal Revenue Code for determining the maximum pay under a defined contribution plan ($220,000 for 2006). The permissible amount must be paid out completely by the end of the second year following the year in which the involuntary termination occurred.

Planning Suggestions:

-- Amend agreements to take advantage of 2-1/2 month payment requirement.

-- Consider whether it is financially feasible to take advantage of the deferral of the 2-1/2 month feature (which would require no payments until at least five years after the eventual termination date).

-- Where appropriate, limit the dollar amount paid to comply with the exemption based on the dollar amount paid.

SPECIAL PROVISIONS FOR "KEY EMPLOYEES" OF PUBLIC COMPANIES

The effect of Section 409A on severance payments is particularly important for senior executives of public companies. Congress included a special provision that requires that for payments that are subject to the new law that are paid to "key employees" of such companies, payments must be delayed for six months following termination. This delay could require that an executive find other sources of income for living expenses for the first six months following the end of his or her employment.

Generally, an employee will be considered a "key employee" if he or she had been among the top-50 most highly compensated officers. "Key employees" who are being involuntarily terminated can avoid the payment delay requirements of Section 409A if the two-times annual compensation/$440,000 (for 2006) limit is observed, or if the 2-1/2 month short-term deferral provisions are available. (However, as described below, the result is not the same if employment is terminating because the employee has "good reason" to do so.)

If the six-month payment delay cannot be avoided because the severance payments will not meet the 2-1/2 month short term deferral rule and will be more than $440,000 (for 2006), then the new regulations require that the severance arrangements specify exactly how the "catch up" will work following the delay. The regulations permit either paying the full amount delayed on the first possible date for payment or simply delaying by six months all payments.

Planning Suggestion:

-- Add "catch-up" provision to agreements providing that if the employee is a "specified employee" under Section 409A(a)(2)(B)(ii), and any payment would subject the employee to tax under Section 409A, then payment will be delayed until the first date that payment can be made without subjecting the employee to the tax.

SEVERANCE PAYMENTS AFTER INVOLUNTARY TERMINATIONS – PAYMENT TERMS *NOT* NEGOTIATED IN ADVANCE

The proposed IRS regulations recognize that in many cases, the amount and timing of severance pay following an involuntary termination are not negotiated in advance, but rather are negotiated at the time of the termination. The general rule under Section 409A is that an election to defer compensation must be made in the year before the year in which services are performed. Obviously, this would not be possible in the case of severance payments being negotiated at the time of termination.

Accordingly, the proposed regulations provide that so long as there are "bona fide, arm's length negotiations", the election as to time and form of payment may be made on or before the date that the employee receives a legally binding right to the payment (usually the date the severance agreement is signed). Apparently, the IRS is concerned that executives who are leaving a company might use their leverage over other personnel with whom they are negotiating to

extract a deferred compensation arrangement the terms of which are in reality controlled by the executive.

Planning Suggestion:

-- Executives without severance arrangements already negotiated should be prepared to demonstrate that if and when negotiations must occur, they are conducted in a manner fair to both the executive and the employer.

SEVERANCE PAYMENTS AFTER "GOOD REASON" TERMINATIONS

It is very common for executives to have arrangements in place permitting them to receive severance payments upon the happening of a "good reason" for the employee to terminate his or her employment. Usually, these reasons would constitute a "constructive discharge" and include such events as being demoted, being required to accept a lateral position or being required to move the executive's principal office location. It is particularly common to see such arrangements become effective following a change in control of the employer.

The proposed regulations deal with "good reason" arrangements rather harshly, by labeling them as not involving the requisite "substantial risk of forfeiture". Accordingly, "good reason" terminations would likely not even be eligible for any of the exceptions from 409A coverage described above. The IRS has requested comment on what further guidance would be useful in these arrangements. However, it is unlikely that the IRS will accept most "good reason" grounds for terminating employment as the equivalent of an involuntary severance.

Planning Suggestions:

-- Until the IRS provides further guidance, "good reason" separation pay arrangements should be written and administered in compliance with Section 409A in all respects.

-- Because this treatment of "good reason" terminations would mean that payments to "key employees" could not be made earlier than six months after termination, agreements should be amended to specify how to "catch up" for the six-month delay.

-- Consider eliminating "good reason" provisions from agreements and paying severance based on events outside of employee's control, at least where it is unlikely that "good reason" provisions would be utilized.

CHANGE IN CONTROL-RELATED PAYMENTS

In most cases, change in control agreements will not present Section 409A problems, because the executive loses his or her job involuntarily and amounts are payable immediately upon separation from service. However, many such agreements provide that amounts will be owing if the employee has a "good reason" for terminating employment. As noted above, the IRS has taken a very dim view of such provisions in the proposed regulations. As a result, executives with such "good reason" provisions in their agreements should be prepared to be taxed immediately upon the change in control, even if they retain their jobs and lack a "good reason" for terminating their employment.

It is also not unusual for employers to make discretionary, early cash-outs of equity awards following a change in control. Section 409A prohibits an employer from retaining discretion to accelerate payments. The proposed regulations allow for payments incident to a change in control when made between 30 days before and 12 months after termination and only if following a "change in control". Importantly, the regulations use a very traditional definition of "change in control", so if an agreement has a more liberal definition, then this favorable treatment would not be available.

Planning Suggestions:

-- Consider financial implications of owing tax, even before a good reason termination event occurs, on full amount of severance payment following change in control.

-- Consider eliminating "good reason" provisions be eliminated from change in control agreements, and automatically paying severance following a change in control, at least where it is unlikely that "good reason" provisions would be utilized. (This arrangement is sometimes referred to as a "single trigger" change in control agreement.)

-- Review the definition of "change in control" in agreements to determine if it conforms with the definition in the regulation.

-- Eliminate employee's ability in change in control agreements to elect between a lump sum and installment payments, or alternatively require election to be made at time agreement is first entered into.

POST-EMPLOYMENT REIMBURSEMENT OF MEDICAL INSURANCE PREMIUMS AND OTHER EXPENSES

Executives occasionally have agreements requiring they be reimbursed for certain expenses following termination of their employment. These arrangements can include reimbursement of medical expenses, moving expenses and outplacement expenses, as well as the provision of in-kind benefits or direct payments to a third party providing goods or services to the employee. Most often, such arrangements are contained in change in control agreements and last for a year or more.

The IRS has provided limited relief for these arrangements from Section 409A, by exempting reimbursement arrangements related to a termination if the expenses are incurred and reimbursed before the end of the second calendar year following the calendar year in which the termination occurs.

Planning Suggestions:

-- Consider revising the time period for expense reimbursement provisions so that they comply with the proposed regulations.

-- Consider upfront, lump-sum cash payments that compensate for extended health care insurance premium payments and other expense reimbursement items.

-- Add "catch-up" provision for any "key employee" of a public company who might receive a health care or other post-employment reimbursement benefit that extends beyond the permissible time period (see "Special Provisions for 'Key Employees' of Public Companies" above).