

Reminder: Transition Relief for Code Section 409A Deferred Compensation Arrangements Expires on December 31, 2008

August 29, 2008

The relatively liberal transition relief rules applicable to deferred compensation arrangements under Section 409A of the Internal Revenue Code ("Section 409A") expires on December 31, 2008. These transition rules generally provide employers with an opportunity to amend otherwise non-compliant deferred compensation arrangements to bring them into compliance with the new tax regime without penalty. While "operational compliance" with Section 409A has been required since January 1, 2005, the existing transition relief rules only give employers until the end of 2008 to bring their nonqualified deferred compensation arrangements into full "documentary compliance" with Section 409A.¹ Failure to comply with Section 409A (whether from an "operational" or a "documentary" compliance standpoint) may subject affected employees and other service providers to immediate taxation on amounts payable under nonqualified deferred compensation arrangements, plus an additional 20% penalty tax (with interest) on such amounts.

FINAL REGULATIONS ARE EFFECTIVE JANUARY 1, 2009

The Department of Treasury ("Treasury") issued final regulations under Section 409A in 2007, but the effective date of those regulations was delayed until January 1, 2009 (the "Final 409A Regulations"). During the remainder of 2008, taxpayers may continue to rely on either Treasury's Notice 2005-1 (issued on January 5, 2005) or the Final 409A Regulations for purposes of demonstrating "good faith" operational compliance with Section 409A. However, beginning January 1, 2009, compliance with the Final 409A Regulations will become mandatory and taxpayers will no longer be able to rely on Notice 2005-1 or make amendments with as much freedom as that offered under the transition rules.

As a result of the closing of this window for making amendments, we are reminding clients to review their arrangements with their regular tax and benefits counsel well in advance of December 31, 2008.

DEFINITION OF NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

As a reminder, the following arrangements often constitute or include "nonqualified deferred compensation arrangements" that must be brought into full compliance with the Final 409A Regulations:

¹ Our prior memoranda addressing guidance from Treasury regarding Section 409A can be found on our website at <http://www.simpsonthacher.com>.

- Deferred compensation plans
- Severance pay plans
- Employment and severance agreements
- Equity incentive plans (e.g., restricted stock unit, phantom share, option and SAR plans)
- Annual or multi-year bonus plans
- Supplemental retirement plans (SERPs)

DOCUMENTARY COMPLIANCE REQUIREMENTS

The following is a list of some of the key items that the Final 409A Regulations require of all nonqualified deferred compensation arrangements:

- The arrangements must be in writing (a “plan document”);
- The plan document must provide for a compliant time and form of payment with respect to deferred amounts;
- The plan document generally may not permit payouts to be accelerated on a discretionary basis;
- The plan document must provide that any initial deferral elections or “re-deferral” elections must meet the special timing requirements under Section 409A;
- Publicly traded companies (including all companies within a “controlled group” that includes a publicly traded company) must ensure that their plan document contains appropriate provisions to delay any deferred compensation payouts to “specified employees” (generally the top 50 compensated officers within the controlled group) that are triggered based on a separation from service until a date that is at least 6 months after the separation from service. This frequently requires that severance agreements for “top 50” officers be amended to provide for the six-month delay to the extent that severance payments could constitute deferred compensation for purposes of Section 409A.

EXPIRING TRANSITION RELIEF RULES

Changes in Payment Elections. The transition relief regarding an employee’s or employer’s ability to change the time or form of deferred payment elections without regard to the normal limitations under Section 409A (such as the requirement that any re-deferral of compensation be for at least an additional five years from the previously scheduled distribution date) lasts only until the end of 2008. Therefore, taxpayers wishing to take advantage of these rules will need to act in advance of year-end. As noted in our prior memoranda regarding Section 409A, an election made during 2008 to change the time of payment (1) may apply only to amounts that would not otherwise be payable in 2008 and (2) may not accelerate the payment of an amount into 2008 that would not otherwise be payable in 2008 in accordance with the terms of the existing arrangement.

Payments Linked to Tax-Qualified Plans. The ability to link a payment election under a nonqualified deferred compensation plan such as a "SERP" to an election under a corresponding tax-qualified retirement plan continues for the duration of 2008, so long as the plan governing such a linked election has provided for such linkage since October 3, 2004. For example, where a nonqualified deferred compensation plan provided, as of October 3, 2004, that the time and form of payment under the plan will be the same time and form of payment elected by the employee under a tax-qualified retirement plan, the plan administrator may begin payments on or prior to December 31, 2008 pursuant to the payment election under the qualified plan, even if the normal timing of payment election rules under Section 409A have not otherwise been met. However, commencing January 1, 2009, all such nonqualified deferred compensation plans will need to comply with the timing of payment election rules under Section 409A and will no longer be able to rely on the "linked plan" exception.

Corrective Actions for Discount Options and SARs. "Discount" stock options and stock appreciation rights ("SARs") – that is, options and SARs granted with an exercise price that was less than the grant date fair market value of the underlying stock– generally run afoul of Section 409A. The existing transition relief rules generally permit corrective action to be taken on or prior to December 31, 2008 to correct any such defective option or SAR grants. However, commencing January 1, 2009, any "discount" grants that remain outstanding will generally trigger a Section 409A violation.

ACTION ITEMS

- As noted above, all nonqualified deferred compensation arrangements must be in written form and the terms of each such arrangement must comply with the requirements of Section 409A by no later than December 31, 2008;
- Publicly traded companies (including companies listed on non-U.S. exchanges or on an over-the-counter market) must establish a uniform procedure by which "specified employees" are determined and can be identified on an ongoing basis, in order to ensure that payments that are required to be delayed for six months upon such employee's separation from service are flagged as such at an administrative level;
- Privately held companies should establish a procedure by which the fair market value of its common stock is determined in connection with the grant of any stock options and stock appreciation rights, to ensure that stock options and stock appreciation rights are granted with exercise prices that are not less than the fair market value of the stock subject to such awards on the date of grant.

If you have any questions regarding these important developments, please do not hesitate to contact any of the following or your Simpson Thacher relationship partner:

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