

Key issues and current Q&A: Nonqualified deferred compensation under Section 409A

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New rules for nonqualified deferred compensation plans went into effect on Jan. 1, 2005. However, the IRS has extended many of the compliance deadlines related to these rules to Dec. 31, 2008. With the deadline in close proximity, many people, including CEOs, CFOs, controllers and tax directors, still have many questions about the impact of the rules.

In a roundtable webcast on June 11, 2008, Grant Thornton compensation and benefits consulting professionals discussed how to implement the rules under Section 409A and the required actions that must be completed by the end of 2008. The webcast included a case study and practical examples that provided participants with an understanding of Section 409A and the actions employers must take before the compliance deadline expires. In addition to highlighting many aspects of Section 409A and key issues that are encountered in applying the rules, the webcast provided a forum for participants to ask top-of-mind questions of the Grant Thornton team.

Key Section 409A issues

- Compliance failures often result in tax penalties that are imposed on employees. Failures may be costly for an employer who chooses to “gross-up” the employee for the penalties.
- Section 409A defines deferred compensation broadly as a promise made in one tax year to pay compensation in a later tax year.
- The broad definition of deferred compensation may also include “handshake” agreements, which must be put in writing.
- The Section 409A rules apply to deferred compensation between a company and its employees, some of its independent contractors and board of director’s members.

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- Section 409A limits the circumstances under which a distribution can be made to an employee, an example being a separation from service. A separation from service occurs only if the employee's services permanently decrease to 20 percent or less of the employee's average level of services performed over the immediately preceding 36-month period.
- Termination of a deferred compensation plan, followed by a comparable increase in the employee's salary, is considered a substitution. Substitutions are considered deemed distributions from the plan, which likely will violate the distribution timing rules.

Managing plan compliance

The Grant Thornton team suggested five steps that employers should consider in order to comply with Section 409A before the compliance deadline expires at the end of 2008:

- 1 Identify arrangements that provide for a compensation deferral.
- 2 Change each arrangement, as necessary, to comply with the rules.
- 3 Develop and implement administrative procedures to drive full operational compliance.
- 4 Prepare written plans by Dec. 31, 2008.
- 5 Obtain employee elections as to time and form of payment by Dec. 31, 2008.

Words of wisdom

Based on the experience of Grant Thornton's compensation and benefits professionals in helping clients manage Section 409A compliance, the following are some key points to consider:

- Don't wait too long to get started. The compliance process can take longer than expected.
- Work backwards from Dec. 31, 2008, to develop a compliance timeline.
- Give the company plenty of time to decide what deferral and distribution elections to make available to the employees.
- Take into account the time required for the plan change approval process (e.g., management and board approval).
- Allow plenty of time to put plans and election forms in writing.
- Give employees plenty of time to make elections by Dec. 31, 2008.

Top-of-mind Section 409A questions and answers

The audience attending Grant Thornton's June 11, 2008, Section 409A webcast had many questions on their minds. The following summarizes those questions most frequently asked:

- 1 Can you describe Code Section 409A's requirement that distributions from a nonqualified deferred compensation plan to a specified employee of a public company upon separation from service must be delayed by six months? Could you clarify the applicability of this requirement when a private company goes public and/or when benefits are paid to a key employee under a supplemental executive retirement plan at retirement, where payment begins at age 65, provided that the employee retires?**

Code Section 409A prohibits the payment of deferred compensation to "specified employees" of a public corporation on account of a separation from service until at least six months following the separation from service. The final regulations make clear that for this purpose, a public corporation generally includes not only one whose stock is traded in the United States, but also traded only on a foreign exchange or traded in the United States only in the form of American Depositary Receipts. Thus, if a private company becomes public, any specified employee would be subject to this six-month delay rule upon a separation from service. Furthermore, where a SERP triggers payment upon retirement and attainment of age 65, such payment would also be subject to the six-month delay requirements since the payment triggering event is dependent upon a separation from service.

- 2 Can you describe Code Section 409A's applicability to equity-based compensation programs, such as incentive stock options, nonqualified stock options and restricted stock? Would you please discuss specific issues related to whether nonqualified stock options would be exempt from Code Section 409A, corrections permitted under Code Section 409A when options are discounted and the employer's ability to extend a nonqualified option's term beyond its original expiration date?**

- There are exemptions from Code Section 409A for incentive stock options subject to Code Section 422, employee stock purchase plans subject to Code Section 423 and restricted property such as stock subject to taxation under Code Section 83. Code Section 409A generally does not apply to nonqualified stock options and stock appreciation rights where the exercise price is set at the fair market value on the date of grant and such right does not include any additional deferral feature. However, the stock underlying such rights must be limited to common stock, with no dividend preferences, issued by the direct service recipient company or parent company.

- To the extent a nonqualified option is granted with a discount, such grant could be corrected to meet Code Section 409A’s exemption under IRS transition rules. If the employer intends to re-price the discounted options granted, rather than granting new options and canceling the old grants, such action must be implemented no later than Dec. 31, 2008, in accordance with IRS transition relief provided under Code Section 409A. Thus, the employer may increase the exercise price to the fair market value on the original grant date, which would remove the discount and the arrangement would no longer be subject to Code Section 409A.
- In implementing such a re-pricing, it is imperative that employees not exercise the options until the discount has been eliminated. If the employer chooses not to remove the discount, the employees must choose their exercise dates in advance in order to comply with Code Section 409A. Such exercise dates must be selected no later than Dec. 31, 2008. However, an employee cannot make an election in 2008 to exercise a discounted option during 2008.
- Finally, the final regulations provide that the extension of an option exercise period generally is not treated as an additional deferral feature or a modification of the stock option for purposes of Code Section 409A if the exercise period is not extended beyond the earlier of the original maximum term of the option or 10 years from the original date of grant.

3 With regard to Section 409A’s short-term deferral exemption, does Section 409A apply to a bonus paid beyond March 15 of the year following the year to which the bonus related? Also, is there an exception to the March 15 deadline where the delay in payment of the bonus is attributed to the failure to issue financial statements to which the bonus relates?

Under the short-term deferral rule, Code Section 409A does not apply: (i) where deferred compensation is subject to a substantial risk of forfeiture (“SROF”) and (ii) the compensation is paid no later than the 15th day of the third month following the year the SROF lapses. Thus, for a calendar-year bonus, the payment must be made by the following March 15 in order for the short-term deferral exemption from Section 409A to apply. If the bonus payment is made after March 15, the bonus would be subject to Code Section 409A (assuming the bonus was vested at the end of the preceding year). If the payment is delayed beyond March 15, then the bonus will be subject to Section 409A. Accordingly, the employer should memorialize the bonus arrangement in a plan document. The document should include the payment date in order to comply with Code Section 409A. When specifying the date, it is permissible to specify the entire calendar year as the payment date.

4 Are restricted stock units and phantom stock plans and other such arrangements subject to Code Section 409A?

Both restricted stock units and phantom stock plans are generally subject to Code Section 409A, unless such arrangements meet the requirements of the short-term deferral exemption described above. Thus, if a restricted stock unit vests in one year and the award is settled in cash or stock in the subsequent year by no later than March 15, the restricted stock unit would be exempt from Code Section 409A. A similar argument could be made with respect to phantom stock awards that are paid within the time frame required in order to meet the short-term deferral exemption.

5 Under what circumstances does a promise need to be put in writing in a form that satisfies the requirements of Code Section 409A?

Code Section 409A broadly defines deferred compensation and generally includes any promise if, under its terms and the relevant facts and circumstances, a service provider has a legally binding right during a taxable year to compensation, pursuant to its terms, that is or may be payable to (or on behalf of) the service provider in a later year. Such a promise must be reduced to writing in a document that specifies, at the time the amount is deferred: (i) the amount that the service provider must be paid (or in the case of an amount determined under an objective, nondiscretionary formula, the terms of the formula), (ii) the payment schedule or payment triggering event, (iii) the form of payment and (iv) the six-month delay requirement for payments to specified employees of a public company upon their separation from service. With respect to any deferral election, including an initial or subsequent deferral election, the plan must also specify, by no later than the time by which that election is required to become irrevocable, the conditions under which the election must be made. The plan does not need to be contained in a single document, i.e., multiple documents, such as a basic plan document and related election agreements, can together constitute the plan.

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