Webcast: The Wait Is Over - Facing The Final 409A Regulations
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Presented by: ACC's Corporate & Securities Law Committee, sponsored by Kilpatrick Stockton LLP
Speakers: Lois Colbert, Partner, Kilpatrick Stockton LLP; Dan Hogans, Attorney Advisor in the Office of Benefits Tax Counsel, U. S. Department of Treasury; Jennifer Schumacher, Partner, Kilpatrick Stockton LLP; Mark Wincek, Chair of the Benefits and Labor Department and Partner, Kilpatrick Stockton LLP
Moderator: Sarah Starkweather, Director and Counsel, UBS Securities LLC

ASSOCIATION OF CORPORATE COUNSEL

Moderator: Sarah Starkweather
April 12, 2007
11:30 a.m. CT

Operator: Just a reminder, today's conference is being recorded.

Female: Please go ahead (Sarah).

(Sarah Starkweather): Good afternoon. This is (Sarah Starkweather). I am Director and Counsel for UBS Securities, LLC and I'm also the current Chair of ACC's Corporate and Securities Law Committee which is sponsoring today's webcast. The Corporate and Securities Law Committee is one of the ACC's national committees presenting a number of programs, conference calls, and meetings through the year. We also present several panels at the ACC annual meeting which will be in Chicago this year at the end of October. I would invite anyone who is interested in corporate and securities issues to check our ACC website and participate in our activities.

I am pleased to be the moderator for today's webcast. And, I am pleased to have with me today (Daniel Hogan), Attorney Advisor in the Office of Tax Policy at the US Department of the Treasury in Washington D.C.; (Mark Wincek), a partner with Kilpatrick Stockton LLP in Washington D.C. and the leader of the firm's benefits and compensation practice; (Lois Colbear), also a partner with Kilpatrick Stockton LLP; and (Jennifer Schumacher), also a partner with Kilpatrick Stockton LLP.

Just two days ago, Treasury and the IRS issued an advance copy of the long-awaited final regulations under Section 409A, the topic of today's ACC webcast. Indeed, we have the honor of being one of the very first national programs on the new regulations. We're also very honored to have (Dan Hogan) of the Treasury with us to discuss these new regulations.

We intend to take full advantage of (Dan's) presence today. And so, we have asked to walk us through the final regulations. Also along the way, to keep the focus sharp, (Mark), (Lois) and (Jennifer) will pose questions to (Dan). At the end, we will turn to the questions you have submitted during the webcast. You can do that at any time during the webcast by typing your question in the box in the lower left corner of your screen and clicking send.

The materials for today's webcast can be found on the left-hand side of the web page in the box titled links. There you'll find a copy of the final 409A regulations, a table of contents to assist you in navigating within the lengthy regulations, a red-lined comparison of the final regulation's text against the proposed regulation's text, IRS notice 2007-34 which was released at the same time of the final regulations.

Rebroadcast of this webcast will be available on the ACC website tomorrow and a transcript will be available next week. Transcripts can also be requested using the email address for questions. In that links box you will also see a webcast evaluation form and we would very much appreciate your filling that out for us.

With that, let me thank (Dan Hogan) for generously sharing his time with us today. And, I would also like to thank Kilpatrick Stockton for organizing and sponsoring this program. Let me now turn it over to (Mark Wincek).

(Mark Wincek): Thank you very much (Sarah). Some time has passed since our last ACC webcast on 409A. That followed the September 2005 release of the proposed regulations. As we'll see today, the Treasury and the IRS have been quite busy and quite productively so. Common non-abusive compensation structures like indemnification provisions and (tax close-ups), which it did not and could not work under the proposed regulations, are really (now) non-issues.

Also, there are lots of (liberalizations) and more narrow fixes that solve or at least (salve) specific challenges in complying with Section 409A. And so, I offer my compliments to (Dan) and the other members of the 409A team for their careful thought, hard work very clearly, and I would say gracefulness that the final regulations reflect. Of course, no one would confuse 409A for an easy provision of law. The regulations run to 400-some pages. And, I know that that's of course double-spaced pages so it'll be less in the Federal Register, but 400 pages nonetheless. But, the important thing is the compliance has been really greatly facilitated.

So last, I would like to offer my compliments to (Dan) for getting the final regulations released in time for our webcast today. Great timing (Dan). And with that, I will turn it over to (Dan) and (Jennifer) to give us an overview of the final regulations and the remaining kind of transition considerations in moving towards compliance.

(Daniel Hogan): Thanks (Mark). I do appreciate your kind remarks. We, myself, and (Steve Packney), and (Bill Schmidt) at the IRS, are kind of the core team that worked on this. We worked very hard to try to accommodate as many practices that did not you know offend the requirements of Section 409A as we could. You know with that having been said, you know this is a regime that is quite harsh enough in its own right that we do not need to sort of pile on, if you will, by creating situations where people are going to be tripped up by various provisions.

So with that in mind, I'd like to just briefly describe for you a couple of items with respect to the general structure of this, what really hasn't changed. Then, we're going to talk for a couple of minutes about transition with (Jennifer).

One of the things I'm actually fairly proud of is that the basic structure and the basic principles that we started out with in notice 2005-1 have remained essentially intact. Our definition of non-qualified deferred compensation, although it's been refined, is conceptually unchanged. The definition of the exclusion for short-term deferrals, perhaps the most important conception, you know continues in refined form. And, the various definitions and election opportunities that we provided in the proposed regulations have been certainly refined and enhanced pursuant to the multitude of comments that we received. But, those

continue on, albeit refined, but in you know – in roughly the same terms as originally presented.

Likewise, we were able to make, I think, a few important improvements with respect to the guidance on payments. And so, we have – we'll probably devote a little bit of time to that today. And moreover, I think one of the things that many people are relieved to see is that we devoted – although we were really unable to extend the transition period, the regulations themselves do provide a number of important items with respect to transition relief that I imagine many folks will be glad to see.

In that regard, I think as threshold matter it's important to recognize that these final regulations, while effective January 1, 2008, can be applied retroactively by taxpayers sort of in their own favor, if you will. So, you do have the opportunity to rely on these regs before January 1, 2008. So, if you did something that wasn't permitted under the proposed regs but is permitted under the final regs, you can rely on the final regs in that regard and you know they will protect you.

Taxpayers will be required by December 31, 2007 to bring their documents into compliance with Section 409A. I mean this is a very tall order given the breadth and scope of this provision and the number and type of arrangements that can be affected. In that regard we're going to talk a little bit later about documentary requirements. We tried not to go overboard on that. But, documents you know will have to demonstrate compliance with Section 409A. And, we'll get into the details of that in a bit.

Finally with respect to transition, there were important kind of specific items of transition guidance. And, these were mainly in the – at the end of the preamble but they're also sprinkled into the reg. just a little bit with respect to certain discreet items that people were concerned about. And in this regard, the preamble addresses elections and determinations made during the transition period, for example, with respect to performance-based compensation or separations from service. And, they generally offer some relief in transition that if you made a good faith determination you're not going to have to now change or somehow adapt what you did retroactively based on different guidance in the final reg. So, I think people will be relieved to see that.

Similarly with respect to stock rights, given the fact that we've had you know kind of moving targets in this area we provided some pretty generous transition relief with respect to stock rights that were either awarded or extended during the transition period. And, this is specifically with regard to good faith determinations about whether or not stock is service recipient stock underlying such a right and also with respect to extensions – stock option extensions that occurred on or before April 9 – excuse me – before April 9, 2007.

So with that, I'll turn it over to (Jennifer).

(Jennifer Schumacher): Well, thanks (Dan). I think on that point of being able to look at extensions that were granted before April 10, I think that is an important one and one that many people will be happy about. Can you just kind of explain that again?

(Daniel Hogan): Sure. You know essentially, one of the issues here with respect to stock rights – and you know we'll probably drill down a bit on this with respect to the – to the definitions

portion of this program. But, it's important to recognize that the exclusion for stock rights depends on a couple of key facts; one, that the stock right is not granted at a discount; and two, that it doesn't have an additional deferral feature.

The proposed regulations treated many types of extensions of exercise periods as an additional deferral feature which was applied you know essentially retroactively and it had a pretty catastrophic result. Accordingly, many of the – many people who you know inadvertently did extensions were very concerned that they had created you know an additional deferral feature problem for their stock rights. And, the preamble clarifies that as of April 9, 2007 extensions that were done before that time are not – you know won't be treated as an additional deferral feature.

(Jennifer Schumacher): Thanks (Dan). Just a technical point, I know a lot of people are having trouble with audio. We've been told if you refresh your browser that that might help and just to turn the volume up as high as possible.

(Dan), on the documentary compliance, we're going to get into more detail about what has to go into the plan generally. But, do we have to detail – do we have to detail what happened during this last two-year transition period?

(Daniel Hogan): Well, you know here's the thing. Certainly, as a taxpayer it is incumbent on the taxpayer to be able to demonstrate good faith compliance. Obviously, if you've got things in writing that's easier to do. And so, I think most people have operated under the assumption that they ought to have things in writing to demonstrate their actions and to prove that they were, in fact, in good faith compliance.

With that having been said, the regulations stop short of requiring you know a demonstration in writing of good faith compliance. And, they do not require any sort of – sort of retrospective documentation to show good faith compliance in plan documents or otherwise. You know, certainly to the extent that you took actions during the good – during the – during the transition period, you of course do need to be able to show that you know wherever you're making a judgment call that, in fact, it was a good faith determination.

(Jennifer Schumacher): Great. There's a number of specific transition rules related to the stock rights and related to what is (some specific) stock and initial deferral (elections) that are very helpful. But, we're going to wait and get to those at the end if we have time because there is so much to cover.

So with that, I want to turn it back to (Mark Wincek).

(Mark Wincek): OK. And, you'll see that the slides are in fact proceeding but we're going to be on this slide again for a while. And rest assured, we're speaking as loudly as possible here and hopefully the problem, at some point, will solve itself.

Then, let's turn to those plans that – those rules that govern 409A's coverage. (Dan) give us an overview there please.

(Daniel Hogan): Sure. You know certainly as a threshold matter these rules apply to any plan that provides non-qualified deferred compensation which OK fine. It's a bit of a (tautology). I'll admit. But, the regs then go on to define plan you know in a very broad way. I mean this is

any kind of you know arrangement, program – I mean you know plan is a very broad term. So, recognize that right off the bat.

Non-qualified deferred compensation is similarly a very broad term and that encompasses any legally binding right to essentially taxable compensation in a future year. And then, we go through and sort of define this breadth down through a series of exclusions. The most important one is probably for short-term deferrals. And, this is an exclusion that basically says well if you receive a legally binding right to compensation but that right is subject to a substantial risk of forfeiture and if in connection with the substantial risk of forfeiture you will include the amount in income either in the same taxable year or within two and a half months thereafter then, in fact, it's not a deferral but you know is essentially current compensation. And, it's not subject to Section 409A.

Now, one of the issues, I think, that's come up is where you have – and we'll probably get into this a little bit more when we talk about separation pay because that's where it comes up the most is bifurcating between you know where you have a stream of payments that's triggered by the lapse of a substantial risk of forfeiture but is part of an arrangement that also provides deferred compensation you know whether and to what extent you can bifurcate between those payments that actually fall within the short-term deferral rule and those that don't. And, you know we clarified here that, in fact, you can bifurcate under those circumstances.

(Mark Wincek): Let me just, if I could, jump in for a second (Dan). One of the things that I think is kind of notable – and if everybody that is on the line besides us could mute that would be very helpful. One thing that's very, I think, noteworthy in this is that as the progress

towards more, I'd say, (liberalized) rules went forward it was kind of bolstered by putting in some, I would say, general anti-abuse rules. And so, for example, a new definition of deferred comp or that definition has been expanded to include an arrangement that's necessary to avoid abuse, for example.

(Daniel Hogan): Yes. I mean you know there is a broadly applicable general you know anti-abuse rule that would pull in any arrangement that is designed you know essentially with the purpose of avoiding 409A you know or avoiding the intent of 409A. in other words, if you are merely doing this to provide deferred compensation that should be subject to 409A but you're arguing it shouldn't be, I mean that's cause for concern and that's what the anti-abuse rule is essentially about.

(Mark Wincek): And in a similar vein, under the proposed regulations one could have concluded that if you paid an amount in the same year (if) the right to it was created that would always be not deferred. And, the regs made clear that that could be an acceleration.

(Daniel Hogan): Well, I mean yes. I mean I don't think we ever agreed with that. But, I think – you know I think there was an argument about whether we were sufficiently clear. And, one of the things we've tried to do with the final regs is to make abundantly clear that you have to make the determination about whether a legally binding right provides deferred – provides for deferred compensation at the time it arises. And, if under that right at the time it arises it does or could provide deferred compensation – for example, you've got a triggering payment event that is an uncertain event. But, if that event could happen after the short-term deferral period you've got a deferred comp promise. You're subject to the anti-acceleration rule. And so, you know as soon as you make that promise you're wired into the 409A restrictions.

(Mark Wincek): Yes. And a similar rule (carried off) into short-term deferral exceptions. So, to the extent that you have the payment occur before the short-term deferral period that won't be an exception if it was scheduled to have been paid at a later stage.

(Daniel Hogan): That's right. I mean you can not bootstrap yourself into a short-term deferral from a promise that provides for the potentiality for deferred compensation. You know on the flip side, where you don't specify at all whether something is going to be deferred or not you do have an opportunity to pay it within the short-term deferral period. But if you don't, then you have a non-compliant 409A obligation and you've got to – you've got yourself a real problem.

(Mark Wincek): OK. Why don't we sort of jump over and talk about stock rights, options and SAR's?

(Daniel Hogan): Sure. And, this is probably the area where there's the biggest sigh of relief. Although, I think you know most people – you know given the volume of commentary that we got on the proposed regs were expecting some loosening on these points. But essentially, the problem areas under the proposed regulations as observed by commentaries were two-fold.

First, the definition of service-recipient stock that can be subject to these excludable rights was viewed as much too limited under the proposed reg. And second, there was a pretty harsh rule that I mentioned in the beginning regarding stock right extensions that likewise

was very restrictive on the ability to extend an exercise, you know a stock option exercise period, even within the original outside term of the option.

And so, we went back to the drawing board there. And so, first of all a couple of things remain unchanged. You know this only applies – the exclusion only applies to stock rights that are granted without a discount. In other words, the underlying securities fair market value (at date of) grant that equals the exercise price. The exercise price can never be less than that.

Second, there can't be any additional deferral feature as defined under the final regs. And third, you know you have to exercise – you have to recognize the income on exercise. So, those are the basic requirements and those haven't changed. The particulars have. With respect to the service recipient stock, now you have the same rule for public and private companies both and that is that it has to be section 305 common stock within the meaning of the code. It can not have distribution preferences other than liquidation preferences. And, that's basically it. I mean there's some – you know there's some restrictions on putting (call) rights and that sort of thing. But, the basic idea is it's got to be common stock with no dividend preferences. And generally, that's going to qualify as service-recipient stock.

Now, we'll also probably talk here in a minute about who the eligible service recipient issuers are. But, that's the eligible class of stock. On the extensions, you know we basically liberalized the rule. The idea here was Congress wanted to shut down option (gaining) deferrals. They were really annoyed about that. And so, you know we took that – took them at their word and actually you know shutdown option extensions too in the proposed regulations. I think everybody felt like that was going a bit too far.

And so, you know the general prohibition on option (gaining) deferrals remains. Anybody who tells you, you can do an option (gaining) deferral on an excludable option is just plain wrong. If you want to do an option (gaining) deferral you've got to structure the thing as subject to 409A from the beginning.

With respect to the extension of a stock right – and this comes up a lot in reductions in force and separation from service – where you want to extend an option (in that context) or otherwise you can under the final regs without having it treated as a – as an additional deferral feature, extend the exercise period up to the outside original term of the option or if less 10 years from the date of grant. So, that gives you a little more flexibility to give people relief with respect to post-termination exercise periods where you know you're leaving – they're leaving on good terms. You kind of feel bad about it. You want to you know allow them have a little continued upside in the company. That is – that is an option – or excuse me – an alternative that is now available to you.

(Mark Wincek): And just to be clear on that (Dan), if you read the preamble you could get the impression that that special rule for extensions you just talked about that allows you to extend to the full term of the option as originally set forth only applies in connection with somebody terminating employment. And, I think actually if you read the regulation itself it's pretty clear that it applies for whatever situation might cause it to shorten the option and exercise period. But, you can still for whatever the reason might be that's causing that, push it out to the original maximum term.

(Daniel Hogan): That's right. Although, I mean – I think as a practical matter, this comes up most often in the separation from service context but you're exactly right. The language of the regulation doesn't limit it to that.

(Mark Wincek): And just a couple of points – I've put a note here that our significant is – some nice tweaks on the valuation rules for privately held or non-publicly traded companies. For example, you don't have to have consistency between one (date's violation) and another and things of that sort, so things to look for in that area as well.

But, I think certainly the extension thing is a huge and extremely helpful change. One of the regs that make it kind of clear is that at the back end of the process if the actual settlement of the option or payment of the SAR is delayed that it can now be delayed for any legal reason at all, not just securities law reasons, and it also can be delayed in the event that the liability of the issuer would be threatened if it – if it were not delayed.

(Daniel Hogan): That's right. I mean so – you have a little bit of flexibility. If paying out on the SAR is going to send you into receivership then you don't – you know you have a little bit of flexibility there, you know, and likewise for securities law restrictions. One other observation I'd just like to make about service recipient for this purpose – because the – you can issue an excludable option on service recipient stock. And for this purpose, the service recipient means the direct service recipient corporation or any corporation in a line of corporations ending with the direct service recipient corporation that has a 50 percent or greater interest. That's the default definition.

You can electively change that by pre-specifying an ownership threshold as high as 80 percent or as low as 20 percent. If you go below 50 you have to be able to demonstrate legitimate business criteria for the issuance. You know this is to accommodate joint ventures and that sort of thing primarily. But, you have also I think some flexibility there about who the issuer is. And, I think people will generally find that helpful. It does track along with what we did in the – in the proposed reg. The difference here is that we changed – we changed the default ownership threshold.

(Mark Wincek): And, I think the other thing that is relevant in a – in this area that got changed is that to go from 50 to 20 percent can be done even though it wasn't sort of pre-specified as long as the business reason that the right to require is in place and that the regs have kind of flushed out what it means to have a valid business reason for that purpose.

(Daniel Hogan): Right.

(Mark Wincek): OK. Just to jump ahead then to foreign plans, we won't get into the details. You all sort of know it in general. There are a number of tweaks here that I think people will find helpful. Just for example, tax equalization arrangements are now going to still be able to be exempt even though the equalization is relative to foreign taxes rather than US taxes, things of that sort.

Well, let's sort of, in the interest of time, move past that. And I'll just note again that (identification) arrangements are basically exempt. If it's a right to be (indemnified) for a legal liability that you incurred because of your employment that simply is exempt.

(Daniel Hogan): That's correct. I mean indemnification, you know (DNO) liability type stuff including (tail) coverage, is not going to be treated as non-qualified deferred compensation subject to 409A. So if I also – you know just on the broad subject of insurance make another comment about an item that we clarified. I mean I think we always intended that you know death benefit – the death benefit plan exclusion would include insured life insurance type benefits as long as it's pure death benefit, pure life insurance, nothing else. You've got to die to get the money. That's the only way you get the money. The final regulations you know make that even more clear that that's exactly what we mean. So, the cost of coverage is not treated as deferred comp. The death benefit itself is not treated as deferred comp as long as it is purely life insurance.

(Mark Wincek): Right, OK. Let's then jump to separation pay which is an extremely important area and that really affects a lot of people in a way that was a concern in many cases. Why don't you give us kind of an overview in that area first, (Dan), if you would?

(Daniel Hogan): Sure. And, you know for better or for worse this is an area which is probably the area in which issues most commonly come up and conceptually is the most difficult. You know we – there's nothing we can really do about that given the nature of what this regulates and the reason that it regulates it. And so, let me start by saying that there are really kind of two principle ways in which separation pay is likely to fall out of the Section 409A requirements.

The first is if the amount is a short-term deferral. In other words, the only way you get the money – the only way you get this particular bucket of money is to get fired. If that's the case, you earned the money by getting fired. And, if they pay it to you right away and the

promise doesn't provide for any deferral then you know you got fired. You earned it. You got paid, no deferral, end of story. So, there's that piece of it.

And, you can see where there's a stream of payments triggered in that context. My earlier comments on bifurcation can come into play. And, that all gets a little bit complicated. With that in mind, we also added a more straightforward kind of simple exclusion, if you will, under the regulations for certain you know particular separation pay plans. And, these are separation pay plans that only pay on involuntary separation as defined. And, that's actually a little more you know sort of complicated than it was before. And, we'll talk about that in a minute – and window programs.

And, here the proposed reg. said well this exclusion applies if you limit the separation pay to two times annual comp capped at the 401A17 limit and it's paid no later than the end of the second year following the year of termination. You know it was kind of an all-or-nothing deal at least the way the proposed regulation framed it that you know if you were under the limit you got the exclusion. If you weren't, it kind of appeared that you didn't. Under the proposed – excuse me – under the final reg., we basically have gone forward with a tweak to this which I think is very important. And, that is that this exclusion now applies on a to-the-extent-that basis.

So, for everyone who is getting separation pay that meets the definition for the first you know two times annual comp capped at the A17 limit paid within the relevant timeframe, you get the exclusion even is the total amount of separation pay you're getting is more than that. And so, I think that's going to ease the administrative burden in making a lot of these determinations. It takes some pressure off of people who find themselves caught by the six-

month delay rule for specified employees. And, I think it makes these rules in a whole lot of ways a little easier to live with. And, we're not talking about enormous amounts of money in that context.

(Mark Wincek): Just to go back to that first thing that you mentioned (Dan) about using the short-term deferral rule to at least allow you to pay those portion – those installments in a stream of payments that occur before the short-term deferral deadline – the requirement in the regulations there is that you can do that as long as each payment is treated as a separate payment under the technical rules of the regulations. And, I – how does that actually get done? Does that get done in my document? How does that mechanically occur?

(Daniel Hogan): Yes. That's a real important caveat. I mean – it's a very important distinction because what's happening here is that for the purposes of the payment rules we've incorporated the definition of payment from the payment provisions generally. Under that rule it basically – it treats any group of ((inaudible)) as a single payment and certainly any annuity as a single payment. So, I think the way to deal with this is – where you want to use this bifurcation is to (sort of) specify in your agreement each payment will be treated as a separate payment for this purpose.

(Mark Wincek): That's great. If somebody can help us with that background noise on the …

(Sarah Starkweather): Yes, if somebody put their phone on hold please take your phone off hold right now. If one of the speakers put your phone on hold please take the hold button off. Sorry about that.

(Mark Wincek): OK, thank you. All right. Well, we'll try to talk as loud as we can to be over that as best we can. So, the – turning then to the two times pay exception. You noted very importantly it applies on a to-the-extent basis. There's been some tweaks around how you determine the compensation to apply that two times compensation limit. It's now the A17 limit for the year of separation. That's been made clear. I think that might have been (intended) all along but it's now been made clear.

(Daniel Hogan): That's right.

(Mark Wincek): And, it also looks back not to sort of actual (415) compensation in the look-back year – the year preceding the year of separation but it looks to a rate of pay during that year. And so, I guess that would probably deal with the case where I have somebody who has an unpaid leave in that – in that year. So, we look at their salary as opposed to what they actually received.

(Daniel Hogan): That's right. I mean you know we're trying to come up with the most fair measuring point that would deal with you know the multitude of circumstances in which this comes up. And so, you know we kind of settled on rate of pay as kind of being the easiest way to deal with that.

(Mark Wincek): OK. Now, what about things that aren't really easily get viewed as a rate of pay. Like, I had options that I exercised. Would that sort of be out of that calculation then?

(Daniel Hogan): Yes.

(Mark Wincek): OK. So, it's really things that are – that are more ratable, your ordinary bonus, your salary and that's basically it.

(Daniel Hogan): Certainly salary.

(Mark Wincek): OK. What about certain (normal) bonus?

(Daniel Hogan): I mean I think that really becomes a fact of the circumstances as to whether that you know is part of your regular pay or not.

(Mark Wincek): So, the focus really in your view is kind of on salary and then beyond that it's more of an issue. And, I guess from an employer perspective one could always apply this more conservatively and know where you stand.

(Daniel Hogan): Right. That's right. I mean – you know but – you know at the same time, I think if you absolutely always get a bonus that's five percent of your pay I mean arguably that's a part of your rate of pay. But, you know where it's a highly variable number I mean I think it's harder to make the argument.

(Mark Wincek): Got you. OK. We'll talk about the definition of involuntary termination which is one of the requirements to get this two times pay rule to apply a little bit later on. But, I'll sort of just note that there are provisions that allow good-reason terminations to qualify. Let's just sort of answer the kind of reimbursement arrangements that oftentimes accompany a separation pay situation. And just as kind of a lead-in to that I'll note that the regulations make clear that each of the specific exceptions that apply in the separation pay area can be

used together so that you don't have to do just one. You can use sort of the aggregate of them for different pieces of the compensation.

(Daniel Hogan): That's right. I mean these essentially can be used on an additive basis as opposed to you know – you don't have to exchange one for another. Each one applies independently and in addition to any of the others.

(Mark Wincek): OK. And so, one of the important exceptions that existed was for reimbursement arrangements, oftentimes for moving expenses or for out-placement services, and so forth. But, there were I think some rough edges in this area that caused people some concerns and a number of them have been kind of straightened out. And, one of them has to do with the treatment of a non-taxable benefit. And, there was a kind of implication on the proposed regulations that might conceivably be you know covered by 409A. The final regulations verify that's not true.

(Daniel Hogan): You know, generally a right to a non-taxable benefit is not going to be subject to 409A. I mean if you can exchange that non-taxable benefit for a taxable benefit the exclusion very well may not apply. This is not an invitation to play games. It's merely a recognition of the fact that if somebody promises to provide you non-taxable health benefits and that's all you're entitled to, you can't swap it for anything else. You know that's not going to generate taxable income. It doesn't involve the deferral of taxable income and accordingly is not subject to 409A.

(Mark Wincek): The reimbursement exception, it's clear, now applies not just to involuntary terminations but also to voluntary ones. That was the case for medical before but not as

clear for the other kinds of things like moving expenses. In the case of the medical, the big issue kind of there was that it required a limitation on how long you could reimburse the medical for. It was based upon when the reimbursement was done. And, that's a tough kind of way to run a medical plan because they tend to look at coverage periods rather than when reimbursements get done. And, it's a pretty big shift to this part of the final regulation.

(Daniel Hogan): Yes, I mean – and another kind of important adjustment we made here is we basically said if you're getting taxable post-termination health benefits for the Cobra period, up to the end of the Cobra period those are not subject to 409A. So, you know it's not an uncommon practice where you have these kind of self-funded discriminatory plans to provide that benefit on a post-termination basis and it's generally not going to be subject to 409A.

If you provide that benefit beyond that period, then to the extent that it exceeds the Cobra period then it will (raise) 409A implications. We'll get into you know how you deal with that a little bit later when we talk about some of the accommodations that were made under the payment provisions.

(Mark Wincek): But, a couple of the keys here are that across the board this is kind of a to-the-extent approach. And so, like in the two times pay exception as you said that applies even if you go over it to the extent that you're under it.

(Daniel Hogan): Right.

(Mark Wincek): In this area, the same thing – it applies to the portion of the medical extension that's within the Cobra period even though you might go beyond it. And you know just to kind of make that specific, I guess that's normally an 18-month Cobra period. But, it could also be 29 months for disability or 36 months for death.

(Daniel Hogan): That's right.

(Mark Wincek): So, whatever that applies – and then, it doesn't really matter when the plan reimburses. The plan's ordinary rules can apply that could allow the year or two years or whatever it is to submit the claims. That's OK.

(Daniel Hogan): That's correct.

(Mark Wincek): In the case of other expenses besides medical, the rule from before of when the expense has to be incurred still applies. It has to be incurred before the end of the second year that begins after the year of the separation. But, we've allowed more time for the actual payment to be made. Right?

(Daniel Hogan): We have.

(Mark Wincek): And, that goes until the third year in that situation. So, (my apologies). And as an expansion of the de minimis exception here from the $5,000 that was in the proposed regulations, (this is) based on the (401K) rules.

(Daniel Hogan): Right. So, we – you know wherever possible we sort of use the 402G limit threshold. Again, I mean one of the things I think we tried to go back here and do is you know provide as much consistency as possible where rules would apply with the same limits in the same ways so that people wouldn't have you know three or four or five different limits that they were trying to keep track of for different purposes.

(Mark Wincek): OK. With that, we now get to turn to a new slide. And, I will turn it over to (Lois) and you (Dan).

(Lois Colbear): OK, thank you (Mark). We'll try to cover a variety of different topics here in this section. And, I want to start with the plan aggregation rule. It's one of the fundamental concepts behind many elements of the regulations and also in understanding what happens if you make a mistake. Can you help explain how the plan aggregation rules work under the final regulations?

(Daniel Hogan): Right. I mean one of the things to recognize here is that you know this is a – that we have this plan concept that exists under the statute. And, it's pretty clear you know from the standpoint of somebody who's been involved in this process through – you know the legislative all the way through that they certainly did not intend for people to sort of, by using different pieces of paper, limit their exposure to section 409A.

I think you know what our regulations reflect is what we think – you know basically the legislative intent was that all similar types of arrangements should be treated as a single plan for this purpose. Now, you wouldn't be able to make you know sort of minimal distinctions or non-distinctions or documentary distinctions and sort of (cordon) off on that basis and

basically turn this into you know what is – what would basically be a significant haircut provision. I don't think that's at all what Congress intended which is why they had you know a plan-wide rule.

I mean note also that, for this purpose, the plan generally is a person-by-person concept. So, a mistake with respect to one person doesn't blow up everybody who's covered by the same document necessarily. So, I mean you know it really kind of works both ways. I mean in many respects this is a taxpayer favorable rule.

Under the proposed regulations we had – I forget whether there was four or five – sort of plan aggregation categories that were each treated as a separate plan. The final regs basically expand that to nine. And, you know this is really not going to affect your everyday life a whole lot. It primarily affects you in two circumstances; one, if you have a failure and you've got to figure out what the extent of the damage is. And, that's the most important one. And second, you know we do use the plan concept a few places in the regulation, most notably when you're trying to determine whether somebody you know is eligible for the new participant 30-day election rule. You know that is this place where you'll have to determine about whether this is a new plan for them or not.

With that having been said, you know the nine categories are basically this – elective, account balance plans – in other words, account balance plans under which you can make an elective deferral – non-elective account balance plans, non-account balance plans; these are primarily going to be your (DB surp) type plans; separation pay plans, reimbursement and in-kind benefit plans are a separate category. Again, the idea here was – for some of these plans where it's real easy to make a mistake, we wanted to sort of put those off by themselves

so that you know a relatively minor (foot fall) you know with respect to relatively minor benefits would not you know contaminate a much larger benefit especially since you know the mistakes in this area are likely to be exactly that. And, the statute doesn't really distinguish between the two. You know?

The sixth category is provided for (slip out) of life insurance arrangements. It should be noted that we issued a side (car) notice to the final regulations which deal specifically with applying the 409A rule to (slip out) a life insurance arrangement. You know it can be kind of a challenging analysis. And with that in mind, we kind of cordoned that off into its own category as well.

Three more – foreign plans, stock rights and then the other category. And, I must tell you I'm kind of at a loss to tell you what might be in that other category. But, it is there to the extent that things don't fall into one of the other eight.

(Lois Colbear): That was my next question. So, you answered that already.

(Daniel Hogan): Sorry.

(Lois Colbear): I think this is a very important modification to the rule because as you said the important point of it is it isolates the consequence of a 409A problem. It further isolates that than what we had under the proposed regulations. OK. I'd like to move now to the requirement you mentioned earlier of having written documentation for a 409A covered arrangement. The final regulations confirm the elements of the plan that have to be put in

writing as well as the time at which the writing has to exist. I'm hoping you can elaborate on those requirements.

(Daniel Hogan): Sure. And this is – this is part of the plan definition in 1.409A-1C. And, you know essentially we make a couple of points here. I mean this is not a really elaborate description. It's not a step-by-step of what has to be in your plan. But, it does describe the basic requirements. And, the basic requirements are that you've got to comply with having the things in your plan that the statute says you've got to have.

That means you know for a non-elective plan, at a minimum, you've got to have – the plan has to reflect a payment – payment conditions that are 409A compliant which also means that if you're a specified employee that that you know – if applicable, that six-month delay provision has to be there for any payment that's triggered by a separation from service.

With respect to elections, the regulations clarify that you do have to have the election provision in your plan document. It has to be in there no later than the deadline for making an election you know where an election is made. So, if you sort of add an elective provision you've got to have the – have it documented in your plan by the deadline that that election would have to become irrevocable under the regulations.

You know beyond that we don't require a lot in the regulations in terms of documentation requirements. We actively worked to minimize required references to the regulations. With that having been said, you know I'd like to make a – or make an observation. And, I think that is from an administrative standpoint the more specific you are about what you want people to do in administering the plan I think the better off you'll be. You really don't want

to create situations where people are exercising discretion because that's bound to raise operational issues and problems.

But from a form compliance with the statute standpoint, you're not required to go into that level of detail. Most of the acceleration provisions, for example, that are permitted under the – you know the acceleration relief that's provided in the regulations. It's not required to be in your document. You can put it in your document if you want. But even if it's not there you can still avail yourself of that relief.

You know so, I guess the other observation that I would make is that with respect to savings clauses – I mean a lot of people would like to just be able to take whatever existing document they have and just say you know "stamp it. You know, no matter what we're going to comply with 409A and be done with it." And, you know I'm here to tell you that that will not save you if you have provisions in your document that directly contradict the statutory requirements or if you lack a provision that the statute requires.

I mean a savings clause is not going to counterbalance that kind of failure. It may – you know I mean there may be good reasons to have it from an interpretational standpoint. You know I'm not saying they're not otherwise good things to have. But, you are obligated under the statutory language to have in your document what the statute says you have to have and that's basically payment conditions and election provisions.

(Lois Colbear): OK. And, to reiterate a point that I think you made earlier, do you have to have those requirements in one document?

(Daniel Hogan): No. And, that's a great point because I actually did miss that one. And, that really is an important one. I mean for this purpose the contract is going to be a function of all the documents that make up the contract. So, it could be in more than one. You know this comes up a lot for international and multinational companies. They've got some sort of global plan document that, for whatever reason, you know if it's a – if the sponsoring company is in a foreign jurisdiction – for whatever reason, they just don't want to change the document.

And, people have been kind of at a loss for "well how do I get to be 409A compliant?" And, I think what this basically allows you to do is to enter in to side agreements that allow you come into 409A compliance. Now again, I want to emphasize in this – in this context that if you have you know provisions under the existing plan document that contradict 409A you've got to specifically count – you know nullify those under your – under your side agreement. I mean just having a 409A savings clause in the side agreement may not get you all the way home.

(Lois Colbear): OK. But you might, for example, be able to put your election rules for deferrals and for payments in your election forms but not in a base document.

(Daniel Hogan): That's right. I mean you could say notwithstanding the terms of the plan you know for U.S. employees you know elections have to be made in the – made in the following way and can only be made in the following way.

(Lois Colbear): OK.

(Daniel Hogan): And, that you know presumably – and they can only be paid in the following way. And, that presumably would allow you to comply.

(Lois Colbear): OK. And moving on now to a new topic which is the definition of substantial risk of forfeiture, the final regulations generally continue the definition that was set out in the proposed regulations with a few helpful enhancements. Can you explain whether conditioning payment on involuntary termination without cause will constitute a substantial risk of forfeiture?

(Daniel Hogan): Well, you know in general – you know we carried forward the substantial risk of forfeiture definition from the proposed regs pretty much intact and basically said that – you know we started with the (83) definition of substantial risk of forfeiture. We said look notwithstanding that we're not going to buy extensions in general; although, we've added a couple of exceptions in the change of control context which we could talk about in a minute.

And, we also said look for this purpose we don't buy (non-competes) as a substantial risk of forfeiture either and that basically continues in the final reg. In the proposed reg. we also said that involuntary separation from service could be a substantial risk of forfeiture. And assuming that it's a condition that you don't sort of expect to happen at the time you enter into the agreement, it generally would be a substantial risk of forfeiture.

What you're alluding to is the fact that we expanded the definition effectively of involuntary separation from service to include not only you know getting fired to also encompass voluntary separations for good reasons you know subject to you know sort of regulatory parameters. And in that regard we've really provided kind of two sets of parameters. One is

a general set that basically said it has to be conditioned on a material negative change. It's based on all the facts and circumstances. You know some key facts are going to be you know whether the amount that you get for terminating for good reason is essentially the same and under the same terms as you would get for getting fired, also whether there's any kind of notice in (cure) provision for the – for the material negative change.

You know that idea is basically carried forward into safe harbor. And, we've provided you know kind of safe harbor language that allows you to pick and choose among specified conditions as long as you put that into the package that the safe harbor provides. You know generally you've got to have a 30-day – a minimum 30-day notice period and a minimum 90-day (cure) period, I think, if I'm remembering my …

(Mark Wincek): ((inaudible)).

(Daniel Hogan): Sorry. Yes. A minimum 90 – you kind of – sorry – a maximum 90-day notice period and a minimum 30-day (cure) period for the occurrence of the good reason condition. Then, that separation from service for good reason can be treated as an involuntary termination which means that can also be treated as a substantial risk of forfeiture or that termination can be an eligible termination for purposes of the exclusion for certain separation pay.

(Lois Colbear): And, I think that's a helpful distinction. Because, one of the concerns we had with the aggregation rule was that the severance pay category only applied to involuntary terminations. And, when there was uncertainty about good reason that might have caused

the severance pay arrangement to move over into the non-account balance category and thereby impact (surps) and other related plans.

(Daniel Hogan): Yes. I mean – and a very fair point. I mean this was a – this was a point on which we got an enormous amount of commentary I mean not only from the tax and benefits community but also from the employment law community. And, it was – you know it was very helpful in allowing us to you know come up with you know definitions and a final rule.

(Mark Wincek): Let me just sort of interject that I think from the standpoint of our employment colleagues the fact that there is a safe harbor there is going to be a real benefit. Some people that don't need to understand in great conceptual depth 409A can have a you know (border plate provision) that this works. I know that works and off I go. The one point I would kind of make though that – you know clearly the adverse impact that is behind somebody's decision to terminate, of course, has to be material. And, I think one of the interesting aspects, if you look at the regulations, is it's not sufficient as I read them – and I'll get the reaction obviously (Dan) – for the event to be a material adverse impact if the documentation was written so that even an immaterial adverse impact would've been sufficient.

So for example, I see a lot of good reason termination provisions that say any reduction in pay, one penny, is good reason. And so, if I had a document written that way but I actually had somebody's pay get cut materially, as I read the regulations, that's not going to fit because it could have been done for less.

(Daniel Hogan): Yes. I mean you know certainly it would not be sufficient in either the short-term referral context or the separation pay exclusion context. Because for the short-term deferral context, it's not clear that you weren't – you wouldn't be treated as vested already you know from the get go. And so, that's why you've got a short-term deferral problem. And, you're – the amount is payable for a reason other than that which would be defined as involuntary separation for purposes of the separation pay exclusion. So, you're likewise out of luck there. So, it really is critical, as you note, to have this documented appropriately in your document if you want to be able to make this work for you.

(Lois Colbear): OK. The regulations also state that the way the parties characterize a termination as voluntary or involuntary will be presumed to properly characterize the situation but that presumption can be rebutted. And, I think that's an important point. The regs (don't) point out – for example, there may be a termination that really is an involuntary termination but the way it's communicated to the world and documented is that it's a resignation. There could be a number of reasons for that.

(Daniel Hogan): Yes. I mean I wanted to just have a blanket rule that said that anybody who resigned in connection with a public statement that said they wanted to spend more time with their family automatically got to claim involuntary. But, I couldn't sell that. So, we had to come up with a (rebuttable) presumption that says that – you know I mean presumptively if you – if the paper says you resigned we have to assume you resigned. However, you know there may be other facts and circumstance that indicate that you know if you hadn't resigned you would've been fired you know moments later.

And you know, so in that situation I think we're more willing to believe that perhaps it's involuntary. It does create, I think, some issues with documentation. But, you know that I'm sure will be worked out over time.

(Mark Wincek): What if the parties say "Our public position is that resign but we hereby agree between us that you have been terminated involuntarily."

(Daniel Hogan): I mean I would think that that's a helpful fact. I mean it may not ultimately be (dispositive). It may be – I mean I think it has to be taken in the context of all the other facts and circumstances. But, you know assuming that you're not in a real chummy position with everybody and that things haven't been going your way so much lately and there's a lot of friction you know in that situation, yes. I mean I think there are reasons why you might kind of have a side letter or something.

(Lois Colbear): OK. One last question on this topic. It is a requirement that an employment sign a release of claim in order to get a payment. Will that be a substantial risk of forfeiture?

(Daniel Hogan): No.

(Lois Colbear): OK. We'll now move on to initial deferral elections. And, the regulations contain a number of sort of important new special rules in this regard. And, I'd like to talk about a few of them. Some plans are structured so that the employee does not have a choice over the time and form of payment. When would the employer be required to set in stone the time and form of payment under such an arrangement?

(Daniel Hogan): Yes. I mean one of the things we did in the final regulations was to clarify that a service recipient has the same opportunities that a service provider has to set the time and form of payment. So, you know and that would allow, for example, if a service recipient wants to have the option of overriding a service provider's election they could do that as long as they do it before the time that the service provider's election would be required to be irrevocable. So, it's subject to the same timeframes, the same opportunities that the service provider is permitted to have under the – under the regulation.

(Lois Colbear): OK. And, the regulations continue the extended election period for performance-based compensation. And, there have been some concerns as to what would happen if the service provider terminated employment in the middle of the performance period. How is that addressed in the final regs?

(Daniel Hogan): Yes. I mean you know this is kind of a – gets to be a little bit of an esoteric question about performance-based compensation and service period. And you know what was meant by all this was – you know to cut to the chase, in the final reg. we basically said in order to make a valid election under the performance-based rule your service period, at a minimum, has to include – or has to be between the time that the criteria or established, or if later, the beginning of the – of the performance period, ending on the date that you make the election.

So, you know if you terminate after making the election or if you joined after the beginning of the period but before they set the criteria, in both of those situations you'd have the opportunity to have a valid performance-based election.

(Lois Colbear): OK. And, what would happen if the arrangement provided for payout without regard to those performance conditions if the person died or became disabled or if there was a change in control?

(Daniel Hogan): Well, we provided some – an opportunity for you know the election not to apply in those – in those circumstances.

(Lois Colbear): OK.

(Daniel Hogan): But, I mean you've got to – you do – there is a default under the reg. And, if you want a different – if you want a different rule you do have to specify it.

(Lois Colbear): OK. Initial eligibility – there is also a continuation of the special rule for an individual who first becomes eligible for a plan that they can make an initial deferral election within 30 days. How does that rule apply if there are multiple plans of the same category within an employer, for example, two account balance plans?

(Daniel Hogan): Well, I mean you – the plan aggregation rule applies for this purpose. So, if you're already in an elective account balance plan you're not going to be treated as a new participant for purposes of this rule, this 30-day rule, if they adopt another elective account balance plan. You know on the other hand, if all they have is a non-elective account balance plan and they adopt an elective account balance plan you know that would be a new plan for purposes of you, the participant, and you would have the 30-day election opportunity.

And, the idea here is to keep people from you know adopting you know new, essentially identical plans to give people a shot at this 30-day rule. You can't do that. But, there is – you know given the number of different plan categories here, you do have I think some flexibility to use this where the plan you're adopting is not like the other plan you have already.

(Lois Colbear): OK. And, another concern that came up in this category is what happens if someone is participating in a plan; they then cease to participate either because they've terminated employment or because they've moved into an ineligible class of employment and then they again become eligible? Is there an opportunity to reuse that initial eligibility rule?

(Daniel Hogan): There is. I mean basically we've got kind of a 24-month hold-out rule that says you know if you are out of the plan for 24 months and you come back – you know not fully cashed out mind you, just not eligible to defer under the plan, you know in that situation you would be able to be treated as a new participant.

(Lois Colbear): OK. And one last question in this category. Often there will be no pre-established severance agreement or severance arrangement with an employee but at the time they are terminating the parties will negotiate for some severance pay. Is it possible to make a deferral election and add to that ad hoc severance pay arrangement?

(Daniel Hogan): Well, let me put it this way. I mean it's possible to agree to a payment schedule that includes deferred payments. I mean you know we kind of get into this kind of chicken and egg thing about whether it's an election or a negotiation …

(Lois Colbear): Right.

(Daniel Hogan): … or whatever it is. but, you know for purposes of regulation if at the time the legally binding right arises you have established payment terms you know including those that provide for deferral that can be treated as a timely establishment of those payment terms for purposes of the 409A election.

(Lois Colbear): OK.

Female: A listener has asked, "Could that include basically deferring it into an existing plan?" So, you get the severance pay and basically decide, as part of the deal, a contribution is going to be made into the deferred comp plan.

(Daniel Hogan): Well, I mean you know as a contractual matter I don't see why that would be a problem. I mean really you're just kind of incorporating by reference the terms of that other plan to govern the terms of payment that would apply to that deferred amount so it doesn't seem inherently problematic.

(Lois Colbear): OK. I'd like to move now into the rule for time and form of payment. The regulations continue to provide generally that a single time and form of payment must be designated for each payment that's payable upon a particular event but there are some caveats to that rule. Can you help us understand how that works?

(Daniel Hogan): Well, you know as a – as a general proposition where you've got an event-based payment you can specify a different schedule depending on whether the event occurs before

or after a particular date. That applies across the board. For separation from service specifically, we have provided a couple of additional opportunities to make distinctions.

Let me emphasize something we did not do. You can not have a different payment schedule depending on whether you are voluntarily or involuntarily terminated. You must – you know that is not a valid distinction for this purpose. However, you can have a different schedule specified based on – before or after a certain date, as I – as I just mentioned based on attainment of age and years of service. And, that would be an alternative to before or after a specified date. You couldn't use both the specified date and then have a separate inflection point for age and years of service. Those are kind of alternative.

You can also specify a different payment schedule based on a separation from service within a specified period after a change in control. So, I mean you know we wanted to accommodate the fact that you might have elected a life annuity but you know if you're getting – if you're terminating it within a year or two of a change in control you might very well want a lump sum. And since the change in control really isn't within your – in your power, that seemed like a reasonable thing to accommodate.

(Lois Colbear): OK. What happens if you have a specified payment date but for whatever reason you can't make the payment on time? It slips beyond. Do you automatically have a violation or is there some flexibility there?

(Daniel Hogan): Well, there's some flexibility but it's pretty limited. I mean you know the idea here is you know – well first of all, I mean there's flexibility provided for (162M) limitations

and that's kind of a separate issue. But, with respect to payment timing in general I'll offer a few observations.

The first is that the general rule is you've got to pay on or after the specified date but within the same taxable year, or if later, within two and a half months of the specified date or event. That's the general rule. You generally can not pay before the specified event or the specified date. However, you know recognizing that people are human we did add a provision that basically gives you a 30-day grace period in advance of the specified date or event that if you sort of accidentally pay in that period – you know that's giving anybody a choice or anything – but if you pay it within that period it's not going to be treated as a violation. You know if you pay it ahead of that, you're out of luck. And, that also doesn't apply for purposes of the six-month rule. I mean that's a hard and fast statutory rule that we can't really do anything about. So, for specified employees that 30-day rule doesn't help you.

We also provided a blanket exception for provisions that say we'll pay you within 90 days of separation from service or within 90 days of the specified date. So, even though 90 days is more than two and a half months and technically could fall you know outside of the general rule, you know 90 days is such a common provision. We felt like why not just give a special rule for that?

(Lois Colbear): OK. We're running out of time a little bit. So, I'll just mention that there's a helpful rule about tax (gross up) payments that basically make it possible to do those now, whereas before that was a concern. And, I'd like to move quickly just to the – to separation of service. And, the regulations have clarified and I think simplified to a great extent when a

– when a separation of service occurs, foreign employee, and the percentage requirement for a change in the level of a person's service relationship. Can you …

(Daniel Hogan): Right. I mean we basically created a series of presumptions. You know if your – if your service level drops to 20 percent or less of the trailing three-year average service level – and note I'm saying service here. We had comp and services. We use both compensation and services in the proposed reg. We kind of felt like that was too cumbersome. We're focusing on services and the permanent rule. So if your service level drops to 20 percent or less of your trailing three-year average service level, you're going to be presumed to have separated. If it's 50 percent or more of that trailing three-year average, you're presumed not to have separated. And, the determinations in between are based on facts and circumstances.

Something to recognize here is that you know one of the things people were concerned was transfers between affiliates. And so, for this purpose we've adopted a default 50 percent rule that says you know 50 percent owned affiliates are going to be treated as the same employer for this purpose. And, you can you know pre-specify a level as high as 80 percent or as low as 20 percent with legitimate business criteria. But, that does have to be established before the amount which applies is deferred. So, it requires some forward thinking there.

One other observation to make here is with respect to asset sales and the same desk rule or you know so-called. I mean really it's never applied here. But, you know under 401K that's how people think of it. And, the issue is you know where you're selling a whole bunch of people in a line of business and you want it to be as transparent as possible, people were concerned that under the proposed reg. those people would always be treated as having

terminated employment. They'd get paid their deferred comp and they'd be very conscious of the fact that they were working some place different.

And so, the final regulations kind of help deal with that by allowing the employers to elect, in advance of the asset sale, how they're going to treat it as long as it's consistent. So, you can either treat every affected employee as separated or every affected employee as not separated but you do have to be consistent.

(Lois Colbear): OK. Well, thank you (Dan). And with that, I will turn the microphone over to (Jennifer) who is going to talk about the six-month delay for specified employees.

(Jennifer Schumacher): Thanks (Lois). The final regulations contain a number of really additions and clarifications with respect to the six-month delay rule, and more specifically in determining who is a specified employee and therefore who is subject to that six-month delay. Can you kind of give an overview of some of those bigger issues?

(Daniel Hogan): Sure. You know again, to emphasize, you do have to have – if you – if you're a public company – excuse me – if you're a public company you do have to have this in your document for your specified employees. So, if you've got deferred comp payments that are triggered by a separation from service this six-month rule has got to be in your document. It's got to be in your document for each affected employee by the first day that they would be included on a list of the specified employees.

Now we – for better or for worse, we've been forced to provide fairly detailed rules as to how you go about identifying this group of people. The final regulations try to provide even

more detail and mechanics for going about making these identifications. And generally, you know the default is that it applies on a calendar year basis and you have to make the determination for the trailing calendar year ending December 31 and it's applicable for the April 1 of the following year and then applies for 12 months. So, you kind of have this staggered identification year and then applicability year for purposes of your specified employee list.

Now, specified employees are key employees of a public company. It's generally going to be your top 50 officers plus certain …

(Jennifer Schumacher): Shareholders.

(Daniel Hogan): … certain five percent shareholders, et cetera, which doesn't apply to much in this context. But generally, it's going to be your top 50 officers. Now, a couple of points here – we have integrated the 415 – some of the 415 compensation definition rules for this purpose and there are defaults. I mean to the extent that you want to deviate from those defaults it can be permissible but it does have to be pre-specified. So, one of the things I think most employers ought to do is to take a look at these specified employee mechanics and figure out how they want this to work.

I think it's worth making those determinations up front and devoting a little bit of energy to this so that you can figure out what you want to do. And then, just set it and let it run because it will – you know it'll probably run more or less on autopilot after that. But, there may be some documentation. I mean if you're not going to use the regulatory defaults you

do have to have documentation that shows that this is going to be applicable to everybody who is affected by it and you do have to be consistent.

So, what you may want to do is just have all your plan documents say this is all going to be done in accordance with resolutions adopted by the comp committee. And then, have the comp committee you know adopt procedures you know to the extent that they're going to deviate from the regulations. Now, I'm trying to tell you how to run your business. But, you know I mean that's one way that you could go about dealing with this.

Two other points – we you know provided more sort of mechanical detail on how to come up with these lists in various corporate transactions, mergers, spin-offs, public/non-public IPO's. And hopefully, people will find that helpful. We also provided a rule that allows people to use proxy groups so that you can basically say, "All right. I know this list of 150 people will in all cases, every single time, include all of my key employees. And so, I'm just going to identify this group and treat them as if they were my specified employee group because it's easier."

You can do that as long as you pre-specify it, as long as it always includes all of your key employees, and you get relief from the fact that some of these people are going to actually end up having amounts deferred that without some kind of relief would actually violate the elections rules. We give you relief from that in this context. And so, those proxy group designations can be done in accordance with the regulation.

(Jennifer Schumacher): And, there were a couple of issues that came up in the proposed regs related to specified employees that the final regs clarify and answer pretty clearly. One of them is if

you're traded in a foreign country, does that pull you into having specified employees in the U.S.?

(Daniel Hogan): It does. I mean you know the publicly traded definition is a global definition. So, if you're traded on the (LSE) or you know Frankfurt Exchange, whatever it is, you know Hong Kong, and you have employees in the United States, I mean you have a specified employee issue.

(Jennifer Schumacher): And, if you have foreign employees can you count those when you're looking at your group of top 50 highest paid employees?

(Daniel Hogan): You can but you don't have to. And, this is kind of one of those 415 default issues I was talking about. You know recognizing that the people at headquarters in you know whatever country it may be, may not be really that interested in sharing their compensation information with the U.S. subsidiary, we do allow you to – you know you can include them which you know should give you a smaller group of U.S. keys. But, you can also exclude them you know and that's mainly to deal with the situation where they have no interest in sharing that information with you.

But again, I think it would be helpful to identify which way you're going to end up having to go and then to the extent that you need to document that in advance go ahead and get that done.

(Jennifer Schumacher): Put it in your plan or give your comp committee – and have a comp committee resolution that puts all those defaults …

(Daniel Hogan): Exactly.

(Jennifer Schumacher): We are running – we've got about 15 minutes left. So, we're going to skip through some of these. You've alluded to the change in control provision. And, there's been a provision that came up a lot with stock options if you're buying out a stock option in a deal. And, you know what happens when you're not paying that right away? You've made some changes in that area. Can you elaborate?

(Daniel Hogan): Sure. And, this sort of – it deals with a couple of basic rules that you get some relief from in this context. And, this is – this is a change in control rule. So, as a threshold matter to be eligible for this relief it has to be in a change of control context to start with. With that having been said, you know sometimes where you are paying you know contingent amounts to all shareholders, for example, there's some sort of holdback or there's as escrow and it applies to all shareholders you know it'll also apply to compensation denominated in employer stock.

And so, you know those amounts which would normally be payable on a change in control are then going to be deferred and they're not going to be deferred in accordance with the valid deferral election. Well, the proposed regulation gave some relief in that context but capped it at – you know for compensation payable within five years of the change in control.

We expanded on that a little bit to say that where the contingency – you know if it was – if you gained the legally binding right today, it would be treated as a substantial risk of forfeiture that in fact that amount can be treated as eligible for the short-term deferral rule.

So in other words, if the – if the additional amount beyond the five-year period is just so contingent that it really ought to be treated as subject to a substantial risk of forfeiture then that amount can be – can be eligible for the short-term deferral rule notwithstanding the general prohibition on you know additions or extensions of forfeiture conditions.

Similarly, this situation comes up a lot where you've got a couple of key folks in a company who have you know perhaps really large amounts of compensation that are payable upon a change in control. Well, you've got a buyer but the buyer has no interest in actually consummating the transaction if the talent is going to roll right out the door with these big buckets of cash. And so, you know what is sometimes necessary to make these deals go is some sort of restructuring of this change in control – this compensation that would vest on change in control to make it vest you know based on subsequent performance.

And so, we've provided a rule that allows that kind of restructuring of that kind of pay. You know I mean ideally here it's not our goal to impede commerce. And, I think people made the legitimate point that you know you might end up not doing deals that ought to be done merely because of the sort of inflexibility of section 409A. And, I think that's something we tried to deal with.

(Jennifer Schumacher): At this point, we have about 10 minutes left. So, I'm going to go ahead and try to answer some of the questions that have been asked. And, if others of you online have questions please go ahead and submit them. Not particularly in the order they were asked necessarily, "How does this affect privately held companies or do those of us in that position simply get to sit back with no worries?" That was probably picking up on the six-month delay.

(Daniel Hogan): Yes I mean let me just say the general matter – 409A applies to everybody, public/non-public. These are – you know this is a – this is essentially a hybrid accounting method that applies to all taxpayers where you have deferred compensation. I mean that's basically what it amounts to. And so, you know in terms of general applicability you have to worry about this. We have all kinds of special rules provided for you know stock options and stock appreciation rights in the private company context with respect to valuation and some other things.

So, we've dealt with both the public and private distinctions. As noted, you know with respect to the six-month delay for specified employees that only applies to publicly traded companies on U.S. and other international exchanges. And so, that does not apply. That six-month delay does not apply as long as you are and remain a private company. If you are a private company that becomes public then the – you know at the time that you become public the specified employee rule will apply to you and we (helpfully) provided instructions for identifying specified employees in that context in the regulation.

(Jennifer Schumacher): Another question is, "In light of these substantial (complaints costs) involved (to study) and implement these regs both in terms of employee time and legal fees, was any consideration given to a small business exemption along the lines of federal employment statutes, (e.g.) 100 or fewer employees?"

(Daniel Hogan): Well, I mean I really – I can't speak. I mean that would be a legislative decision. I'm sure – I would be shocked if that argument wasn't made. But, I – you know I think that

you know in general there was a feeling that the non-qualified deferred comp rules were not working effectively and they wanted a new regime applicable to all taxpayers.

(Jennifer Schumacher): Next question, “Is an indemnification clause in the employment agreement for 409A penalties eligible for the indemnification exclusion?”

(Daniel Hogan): It is not. I mean because that would base – that would be a tax (gross up). So, you can make it 409A compliant but that type of promise would be treated as a compensatory promise that’s subject to the 409A restriction. Let me explain a little bit why that’s important. I mean if something is excluded then you kind of don’t have to worry about it. But, if it’s not excluded and it’s subject to 409A then you do – you know you’re really kind of limited in what you can do with that promise. For example, you can’t say, “Well we don’t know whether we will or won’t. So, we’re going to settle it out for half the money today.”

I mean that would be an accelerated payment that 409A doesn’t permit. You know, and since that amount is subject to the 409A restrictions you’d actually trigger the penalties by doing that. so, you know that’s one thing to be aware of that this distinction about accommodated under the payment rule and excluded all together you know is kind of an important distinction. Because, once you’re subject to 409A you’re kind of saddled with all of the restrictions and inflexibility that goes along with that.

(Jennifer Schumacher): The next question, “Does legally binding rights have the same meaning as becoming vested under a non-elective or non-account balance (plan)?”

(Daniel Hogan): It does not actually. A legally binding right is really just what it says. A legally binding right is – when I've got a signed contract – I mean all contracts have contingencies in them and not – you know the fact that you know I have a – I have a legally binding right is just a contingent one. It's subject to the contingencies in the contract. So, in the – in the facts described by the questioner, I have a legally binding right but it's subject to a vesting contingency. So, the legally binding right starts when my contractual right you know is created and it exists before it becomes vested.

(Jennifer Schumacher): Great. This one is going to take me a little bit to read. So, you can take a drink of water. "While you (didn't) uncover the topic today, private letter rulings from the IRS have allowed transfers of deferrals from non-qualified plans to qualified plans upon completion of (agency testing). Do the final regs allow highly compensated employees who are eligible for the non-qualified plan to transfer their (collective) distributions from the 401K to the non-qualified (plan)?"

(Daniel Hogan): You know, this is a really – you know and this relay is kind of the – this is a great question. It's a question that basically gets to the heart of the matter in 401K (wrap) arrangements. And, you may notice that we actually had an example on this in the proposed reg. that we took out of the final reg. because this is just such – you know there's so many constituencies to be concerned with here. I mean the DOL has their concerns about prompt remittance of 401K money. The 401K folks have their concerns about contingent benefits and some other things, you know whether or not you can actually correct an over-contribution where the amount is not included in income, for example.

And rather than wade into that, we just kind of provided our blanket relief for adjustments to the amounts under a non-qualified plan in connection with a 401K plan. And, I'd say we kind of leave you to draw your own conclusions about compliance with the K rules and the – and the DOL requirements.

(Jennifer Schumacher): OK. "If an employee can choose between health insurance and deferred compensation, we understand the health insurance becomes subject to 409A. What is the consequences for the health (insurers)?"

(Daniel Hogan): I'm sorry. I'm not sure I understood the question.

(Jennifer Schumacher): They said, "If an employee can choose between health insurance and deferred compensation, that the health insurance becomes subject to 409A?"

(Daniel Hogan): Yes, I mean I would basically say that any choice that involves a 409A deferred comp alternative is going to be 409A deferred comp. I mean in general that's going to be you know the rule. I mean now it's kind of an interesting question. And, I don't know that it's fully answered. I mean certainly you would have to make the choice based on a 409A compliant election comp. I'm not sure it's entirely clear whether the health insurance would be treated as subject to 409A once you did that. I'm going to reserve judgment on that question.

(Jennifer Schumacher): But, if you didn't make that election – if you weren't required to make that election then the 409A compliance period …

(Daniel Hogan): You've got a problem.

(Jennifer Schumacher): Right.

(Daniel Hogan): That's right. I mean you have definitely set – at a minimum, you have set yourself up to have a necessity of satisfying the 409A election timing rule.

(Jennifer Schumacher): "Can a plan be amended to permit payment on change of control of a subsidiary to enable payment to an employee of a subsidiary being sold as long as the payment is not until the next year or later, even if the change of control has already occurred?" I think they're saying can you add in a payment right upon change of control after the change of control has occurred?

(Daniel Hogan): You know the general answer to that is going to be no with a caveat that you know under the transition relief for this year, if you're talking about a (live fact) pattern, you probably would be able to use the transition relief to accomplish your goals. Because, for amounts that in accordance with their current terms are payable next year or later, you do have broad ability to accelerate or you know kind of move furniture as the future year. So, in transition you may be able to accomplish what you want to do. As a general matter after the transition, I would say the answer to that is no.

(Jennifer Schumacher): And, I think it's the last question. "Can you expand on how substantial risk of forfeiture and involuntary termination without cause interact?"

(Daniel Hogan): Yes, I mean I would say that involuntary termination without cause is a subset of substantial risk of forfeiture. Substantial risk of forfeiture you know generally refers to either the performance of substantial services or a condition related to the purpose of the compensation which has you know some sort of you know direct relationship to corporate performance or goals. And, involuntary separation from service would fall into that category as a you know performance related condition and accordingly could be a substantial risk of forfeiture if at the time you enter into the arrangement that condition is not substantially certain to occur.

You know you're not "I'm going to fire you tomorrow. So, we're going to put this in and then we'll call it a substantial risk of forfeiture." I mean you know so there's that question. But, generally it's a subset of substantial risk of forfeiture.

(Mark Wincek): And therefore as a consequence you could have something that's paid conditioned on that qualified for the short-term deferral rule and …

(Daniel Hogan): That's right. You could. The one thing I will caution you on is you know where you have a bucket of money that's subject to multiple promises – in other words, "I'll pay it to you ((inaudible)) voluntarily terminated or I'll pay it to you if you're involuntarily terminated." Well you know that first condition is going to make it deferred comp and the second one is not going to pull it out. So, that's the one thing I think you want to be careful about that you're only going to be eligible to use the short-term deferral rule for a bucket of money with respect to which all promises and conditions are short-term deferrals and none of which are deferred comp.

(Mark Wincek): And, the last thing that I'll say and we'll wrap it up is that there also are provisions in the regulations that address situations where there might be an effort to sort of compensate through monies that are (reportedly) because of an involuntary termination in lieu of other monies that were deferred comp and that would have forfeited in the normal course. Those kinds of trade-offs to replace that forfeited money are going to be looked and viewed with some inquiry.

(Daniel Hogan): Yes, quite a bit of skepticism actually. I mean I think if somebody says, "Well you know we'll just forfeit it and then we're going to enter into a new arrangement" I think you've got to assume that that's going to be a problem.

(Mark Wincek): Well, that's a great way to wrap it up because I think it sort of shows that in this area there are lots of specific rules but you should always be looking towards kind of the general principles behind them. And, a lot of detail but I think as you can see from what (Dan) is saying there's a theme that goes back to kind of the policies in 409A. And, great job today (Dan). So, thanks so much for joining us.

(Daniel Hogan): Thank you very much for having me.

(Sarah Starkweather): OK. Unfortunately we have run out of time. But again, it's (Sarah Starkweather) here. I'd like to thank our panelists (Dan), (Mark), (Lois) and (Jennifer) and all the listeners for participating today. Particular thanks to Kilpatrick Stockton for sponsoring this webcast and getting it organized. If you would like to receive a transcript of today's program, transcripts can be requested from (Mark), (Lois), or (Jennifer) or you can submit a request to (kslegal@kilpatrickstockton.com). And then just a final reminder, please

complete the evaluation form that appears in the links box on the left side of your screen.

Thank you.

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