

**IRS ISSUES FINAL REGULATIONS UNDER SECTION 409A --
EXECUTIVES FACE SEVERE TAX PENALTIES IF PLANS ARE NOT AMENDED BY
DECEMBER 31, 2007**

On April 10, 2007, the Department of the Treasury issued final regulations (the “Final Regulations”) under Section 409A of the Internal Revenue Code (“Section 409A”).¹ The Final Regulations spell out the definitive compliance rules for plans and arrangements that are treated as deferred compensation plans. All such plans must be in *documentary and operational* compliance with the Final Regulations by *no later than December 31, 2007*.

Prior to December 31, 2007, it will be sufficient for plans and agreements to be operated in good faith compliance with Section 409A, Treasury Notice 2005-1² or the Department of the Treasury’s proposed regulations (the “Proposed Regulations”).³ Under the Final Regulations, after December 31, 2007, good faith, operational compliance with Section 409A will no longer be sufficient. In order to avoid a **20% penalty tax** (plus interest) imposed on employees who participate in noncompliant plans, all “nonqualified deferred compensation plans” must be brought into strict compliance with the Final Regulations by no later than December 31, 2007. There are no further grace periods.

The Final Regulations will require significant compliance initiatives, so prompt action is needed. If you have not already asked us for assistance and would like us to review your company’s deferred compensation plans, please call us as soon as possible, and in all events **by June 30, 2007**, so that we can schedule the work that will be needed and make sure that we have obtained all of your plans for review.

WHAT CONSTITUTES A DEFERRED COMPENSATION PLAN?

Section 409A and the Final Regulations broadly define a nonqualified deferred compensation plan as any plan or individual agreement that provides for the deferral of compensation. The following plans and arrangements may have features that will cause them to be treated as nonqualified deferred compensation plans and *must* be reviewed to ensure compliance with Section 409A:

¹ For a discussion of the statutory requirements of Section 409A, see our client memorandum, “American Jobs Creation Act of 2004 Makes Sweeping Changes to Deferred Compensation Rules,” dated October 29, 2004.

² For a discussion of the guidance set forth in Notice 2005-1, see our client memorandum, “Initial Guidance on New Deferred Compensation Rules,” dated December 28, 2004.

³ For a discussion of the Proposed Regulations, see our client memorandum, “Treasury Proposes Deferred Compensation Regulations: Brave New World for Executives,” dated November 7, 2005.

- Equity compensation plans providing for the grant of stock options, stock appreciation rights, phantom stock units, restricted stock units and/or deferred shares, and all related amendments and award agreements;
- Voluntary and mandatory deferred compensation plans and arrangements;
- Severance plans, change-in-control plans and separation agreements;
- Long- and short-term incentive plans;
- Employment and consulting agreements; and
- 401(k) wrap plans and supplemental executive retirement plans and agreements.

This list is by no means exhaustive and many other plans may provide for the deferral of compensation. Please call us if you are unsure about whether a particular plan or arrangement will constitute a nonqualified deferred compensation plan under Section 409A.

SIGNIFICANT CHANGES FROM THE PROPOSED REGULATIONS

While the Final Regulations addressed some of the major concerns raised by practitioners following the issuance of the Proposed Regulations, some of the relief is quite limited. Key changes from the Proposed Regulations are summarized below.

- Extension of Stock Right Exercise Period. Under the Proposed Regulations, the extension of the exercise period of a stock right (*e.g.*, a stock option or stock appreciation right) would cause the stock right to be subject to Section 409A. The Final Regulations provide relief from this general rule and allow the exercise period of stock rights to be extended to a date that is no later than the earlier of (i) the original expiration date of the stock right, or (ii) the 10th anniversary of the original grant date of the stock right.
- Short-term Deferral Exception. Under the Proposed Regulations, if all payments under a plan are *actually* made within 2½ months of the end of the first taxable year (either the employee's or employer's tax year, whichever ends later) in which the payment is no longer subject to a "substantial risk of forfeiture," payments under the plan would not constitute a deferral of compensation under Section 409A. The Final Regulations clarify that the short-term deferral exception will apply only if the payments in question are made pursuant to a plan that does not allow for *any* payments to be made outside of the applicable 2½ month short-term deferral period, regardless of when the payments are actually made.
- Good Reason Terminations. Section 409A requires that amounts payable to a "specified employee" of a public company upon a separation from service must be delayed for six months, unless the payment is not subject to Section 409A (*e.g.*, if the 2½ month short-term deferral rule applies). The Proposed Regulations suggested that amounts payable upon a termination of employment might not be subject to a substantial risk of forfeiture if the amounts could be paid following a termination by an employee for "good reason."

As a result, the specified employee would not have been able to rely on the short-term deferral exception to avoid delaying payments for six months following termination.

- The Final Regulations clarify that amounts payable upon a termination of employment for good reason may qualify as “involuntary” if the good reason termination events are limited to ones that result in a material negative change to the terms or conditions of employment. In addition, the amount, time, and form of payment upon the separation from service must be substantially identical to the amount, time and form of payment due upon a termination without cause. The employee must also provide notice to the employer within 90 days of the initial condition giving rise to the good reason termination, and the employer must have at least 30 days to cure the condition that gave rise to good reason. An employee with a good reason trigger that meets these requirements can rely on the short-term deferral exception to avoid delaying payments for six months following termination.
- Definition of Service Recipient Stock. The definition of “service recipient stock” has been expanded to include any class of common stock, including common stock with a liquidation preference, and the stock may be issued by the employer or any entity that directly or indirectly has a controlling interest in the employer.
- Antiabuse Provisions. The Final Regulations include two antiabuse provisions that limit circumvention of the application of Section 409A. First, if the principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of Section 409A, the plan might be treated as a nonqualified deferred compensation plan regardless of whether it meets the technical definition of a nonqualified deferred compensation plan. Second, a payment of amounts that are in substitution for other deferred compensation rights will be treated as a payment of deferred compensation for purposes of Section 409A. Thus, a payment to make an employee whole for deferred amounts that are otherwise forfeited upon a termination of employment may violate Section 409A.

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If you have any questions concerning the foregoing or would like additional information, please contact Stephen T. Lindo (212-728-8242, slindo@willkie.com), Frank A. Daniele (212-728-8216, fdaniele@willkie.com), David E. Rubinsky (212-728-8635, drubinsky@willkie.com), Peter J. Allman (212-728-8101, pallman@willkie.com), J. Pasco Struhs (212-728-8109, pstruhs@willkie.com), Jordan A. Messinger (212-728-8799, jmessinger@willkie.com), Katie M. Calabrese (212-728-8865, kcalabrese@willkie.com), Jason R. Ertel (212-728-8120, jertel@willkie.com), or the attorney with whom you regularly work.

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