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To Our Clients and Friends *June 11, 2008*

The Short-Term Deferral Rule Can Mitigate the Impact of Section 409A

I. Background

Section 409A of the Internal Revenue Code (the "Code"), enacted in 2004 to regulate nonqualified deferred compensation plans, includes detailed rules that govern when the election to defer compensation must be made and how and when deferred compensation may be paid. The provision applies to a wide array of employee benefit and compensation arrangements, including nonqualified elective deferral plans (such as salary or bonus deferral plans), supplemental executive retirement plans ("SERPs"), and excess benefit plans, and to compensation arrangements for independent contractors and entities that provide services. The broad purview of Section 409A becomes particularly important in light of the potential penalties: if compensation is deferred in a manner that violates Section 409A, that compensation is subject to ordinary income tax at that time (generally, when it is earned, as opposed to when received); an additional 20% tax is imposed; and an interest charge may apply in certain circumstances based on the tax liability deemed to have been deferred.

II. The Short-Term Deferral Rule

Section 409A applies, generally, to all amounts deferred under a "nonqualified deferred compensation plan," defined as any plan that provides for the "deferral of compensation." Treasury Regulations issued last year under Section 409A (the "Regulations") provide that a deferral of compensation occurs, in general, if the employee has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable in a later taxable year. However, a "deferral of compensation" is not considered to occur, with respect to any payment that is not a "deferred payment," if the employee actually or constructively receives the payment before the last day of the "applicable 2-1/2 month period." This rule is commonly referred to as the "short-term deferral rule." As discussed below, the short-term deferral rule is surprisingly flexible, and, when properly used, facilitates a variety of deferred compensation arrangements.

1. *What is the "applicable 2-1/2 month period"?*

In general, the "applicable 2-1/2 month period" is the period that ends on the 15th day of the third month after the end of the later of the employee's or the employer's first taxable year in which the compensation is no longer subject to a substantial risk of forfeiture (i.e., becomes vested).

2. ***What is a "deferred payment"?***

A deferred payment is, generally, a payment made pursuant to a plan that provides for the payment of an amount to an employee on or after a date or event that will or may occur after the end of the applicable 2-1/2 month period, such as upon or after a separation from service, death, disability, change in control, or specified time. A deferred payment does not fall within the scope of the short-term deferral rule, even if payment is made within the applicable 2-1/2 month period.

3. ***How does the short-term deferral rule apply?***

The short-term deferral rule provides that compensation will not be considered a deferral of compensation under Section 409A if the arrangement provides that payment will be made by the last day of the applicable 2-1/2 month period. Therefore, if the compensation was never subject to a substantial risk of forfeiture, it must be paid in the year in which the employee acquired a legally binding right to the payment or within 2-1/2 months thereafter, in order to come within the scope of this rule. For example, if an employee becomes entitled to a bonus on December 31, 2008, and the taxable year of both the employer and the employee is the calendar year, the applicable 2-1/2 month period will end on March 15, 2009.

4. ***Must a plan specifically provide for payment within the applicable 2-1/2 month period?***

A plan does not have to expressly provide for payment within the applicable 2-1/2 month period, so long as (i) the payment is not a "deferred payment" as described above, and (ii) the compensation is actually or constructively received (or otherwise required to be included in income) within the applicable 2-1/2 month period. Accordingly, an employer may maintain, for example, an annual bonus plan that provides for payment of a bonus without specifying when it will be paid, and bonus payments made under such a plan will fall within the short-term deferral exception so long as each payment is made within 2-1/2 months after the end of the year in which the bonus was earned. However, under the Regulations, if payment under such an arrangement is not made within 2-1/2 months after year-end, the bonus plan will not be within the scope of the short-term deferral rule and (under the circumstances described above) will not otherwise be in compliance with the requirements of Section 409A.

By contrast, if the right to an annual bonus under, say, a calendar year bonus plan is set forth in a written plan that also specifies that each bonus is payable on a specified date in the year after the year in which it is earned, payment can be made at any time after the specified payment date (and on or before December 31 of the year that includes the specified payment date) without giving rise to a violation of Section 409A. Thus, specifying a payment date for bonuses to be paid under an annual bonus plan can be highly beneficial even if it is expected that payment will normally be made within 2-1/2 months after the end of the year. For example, a bonus plan of a calendar year employer may provide that the employer will pay to various employees on March 15, 2009, bonuses for 2008 equal to predetermined percentages of the employer's revenue or profits for 2008 (with each employee's bonus being contingent on continued employment through December 31, 2008). If the bonus plan is otherwise in compliance with Section 409A, then, if the bonuses are not actually paid until some date after

March 15, 2009, the bonus plan will generally be considered to be a deferral of compensation within the scope of Section 409A (that is, not within the short-term deferral rule), but will also be compliant with Section 409A so long as the bonuses are paid by December 31, 2009.

5. ***Can the short-term deferral rule ever apply to a payment that is scheduled to be made in the "applicable 2-1/2 month period" but is actually paid thereafter?***

Yes. The Regulations provide a few exceptions to the basic requirement of the short-term deferral rule that payment be made no later than 2-1/2 months following the employer's or the employee's tax year in which the payment is no longer subject to a "substantial risk of forfeiture." Payment may be delayed under certain circumstances (i) if it was administratively impractical to make the payment within the applicable 2-1/2 month period, (ii) if the deduction of the employer with respect to the payment would be precluded by Section 162(m) of the Code (the provision that limits the deductibility of annual compensation paid by publicly traded corporations to certain officers in excess of $1 million), or (iii) where the payment would jeopardize the employer's ability to continue to conduct business. If payment is delayed for one of these reasons, payment must be made as soon as administratively practicable after the end of the applicable 2-1/2 month period or as soon as the payment would no longer have the effect of either a denial of the employer's corporate deduction under Section 162(m) or of jeopardizing the employer's ability to continue as a going concern.

6. ***What are some of the most common uses of Section 409A's short-term deferral rule?***

- An annual bonus paid on or before March 15th after the end of the calendar year in which it was earned (or within 2-1/2 months after the end of the fiscal year in which it was earned, for employers using a fiscal year other than the calendar year).

- A long-term incentive plan in which payments are to "vest" at the end of a certain performance cycle, if certain targets are achieved, and to be paid in the year in which vesting occurs or within 2-1/2 months after the end of that year. For example, a four-year bonus plan with annual targets for performance, but with respect to which a participating employee is not entitled to receive any amount unless the employee remains employed by the employer at the end of the fourth year, will qualify under the short-term deferral rule and will therefore not be a deferral of compensation subject to Section 409A if the amount is required to be paid within 2-1/2 months after the end of the four-year period. In such arrangements, the dates of vesting and payment may be linked to a specific event or hurdle, such as the sale of a specified division or the attainment of a specified level of corporate earnings or sales, even though such an event might not otherwise constitute a permissible payment date if the plan were subject to the requirements of Section 409A.

- A severance arrangement for an employee generally will be within the short-term deferral rule if the payment to the terminated employee is conditioned upon an involuntary termination without cause and is made within the applicable 2-1/2 month period after the separation from service. Further, a termination by the employee for "good reason" (often referred to as a "constructive termination") may be treated as an

involuntary termination without cause for this purpose if the termination for "good reason" occurs under "certain limited bona fide conditions" such that a voluntary separation under those conditions effectively constitutes an involuntary separation from service. This is normally assured by limiting the grounds for termination for "good reason" to those permitted by a safe harbor definition of "good reason" under the Regulations.

7. ***Can reliance on the short-term deferral rule reduce the employer's wage reporting obligations with respect to deferred compensation?***

Relying on the short-term deferral rule may reduce the burden of compliance with wage reporting requirements that are expected to be imposed under Section 409A. These anticipated reporting requirements are expected to include a requirement that amounts deferred be reported in the year of deferral, even though not then includible in income under Section 409A or otherwise. Thus, for deferrals of compensation subject to Section 409A, employers will have the additional administrative burden of ensuring that compensation deferred under these plans is properly reported (and may be penalized for failure to do so), even if the deferral arrangement is compliant with Section 409A. It seems plausible as well that such reporting may itself trigger an audit inquiry focusing on Section 409A issues. In situations where the business objectives of a particular arrangement can be achieved through either of (i) a deferral of compensation subject to Section 409A or (ii) a short-term deferral not subject to the specific requirements of Section 409A, choosing the second alternative may avoid or minimize the employer's reporting obligations relating to Section 409A.

III. Conclusion

Section 409A has already had, and will continue to have, a pronounced impact on the way in which employee benefit plans, severance agreements, employment agreements, and other compensation arrangements are structured, negotiated and documented. The impact will be particularly severe on January 1, 2009, when the Regulations are scheduled to take effect. The short-term deferral rule discussed above is a useful tool for deferring compensation in a manner not subject to the full panoply of rules under Section 409A.

Note: Under transitional relief set forth in various IRS notices, existing deferred compensation covered by Section 409A will generally not be considered to violate Section 409A before 2009 if they have been operated in "good faith" compliance with the statute and IRS Notice 2005-1. Also, arrangements covered by Section 409A may be amended no later than December 31, 2008, to allow employees to change the form and/or timing of payments, including elections that accelerate payments, so long as the amendment does not accelerate the payment of any amount into 2008 or defer the payment of any amount that would otherwise be paid in 2008 to a later year. Employers with deferred compensation arrangements that are not yet in compliance with the Regulations, should take steps to amend or adopt plans no later than December 31, 2008 , so as to come within the short-term deferral rule or to otherwise meet the requirements of Section 409A.

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