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EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

ALERT

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Half a Loaf: IRS Provides Limited Relief from Looming IRC § 409A Deadline

On September 10, 2007, the Internal Revenue Service released Notice 2007-78 (the "Notice"), which provides limited relief from the December 31, 2007 deadline for bringing deferred compensation arrangements¹ subject to Internal Revenue Code § 409A ("409A") into full compliance with 409A and the final 409A regulations. The 409A compliance standard currently in effect through December 31, 2007 is "good faith compliance." The good faith compliance standard, coupled with favorable transition rules on election changes and amending agreements, has provided reasonable flexibility in interpreting and administering 409A.

Note

Failure to comply with 409A, under any standard, will result in an acceleration of income tax, a 20% excise tax and possible interest penalties.

Distribution Elections and Transition Relief

Unfortunately, the Notice does *not* extend (i) the deadline for making distribution election changes; (ii) the good faith compliance standard; or (iii) the transition rules. Accordingly, binding distribution elections that comply with 409A must be made in writing by the end of 2007. 409A permits deferred compensation to be distributed upon:

1. separation from service;
2. change in control;

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3. death;
4. disability;
5. unforeseeable financial emergency for the participant; or
6. a specified date or according to a pre-determined schedule.

Because the transition rules have not been extended, any election changes after December 31, 2007 must be made in a manner consistent with 409A. For example, after December 31, 2007, a subsequent election to defer distribution beyond a specified date must be made more than 12 months in advance of such date and be deferred for a minimum of 5 years. In addition, the Notice also does not extend the deadline for electing whether a series of payments will be treated as a single payment or separate payments, which is particularly important with respect to subsequent election changes.

Documentary Compliance and Specified Employee Delay

The Notice does extend the deadline for amending documents to comply with the form requirements of 409A. This relief provides an additional year to clean up documents that contain valid distribution options, in concept, but which do not meet 409A's very specific definitional requirements. For example, if a deferred compensation plan provides that certain payments will be made upon disability and the definition of disability under the plan does not conform to 409A, the Notice extends the deadline for amending the definition until December 31, 2008. In the alternative, if an employment agreement provides that a payment (assuming the payment is not exempt from 409A under the short-term deferral rule) will be made upon a Series "B" financing, that distribution provision will most likely need to be reformed prior to the end of 2007 since a Series "B" financing is unlikely a change in control and does not fall under one of the other permissible distribution triggers above.

The Notice also extends the deadline for incorporating the 6-month delay for payments to "specified" or "key employees" of publicly traded companies upon termination of employment. The 6-month delay provision must be expressly written into any arrangements that may be covered by such rule. Business entities that anticipate going public should simply incorporate a dormant provision that will become effective upon going public.

Good Reason Triggers

The Notice also clarifies certain questions regarding revisions to existing "good reason" triggers contained in employment (and we

assume other) agreements. After the final regulations were revised to provide that termination by a participant upon good reason would be considered an involuntary termination under 409A, questions arose as to whether a modification to an existing good reason definition would be permissible because the IRS had previously announced that a “substantial risk of forfeiture” (*e.g.*, a requirement to continue performing services before payment could be triggered) could not be incorporated into an arrangement after the service period in question began. The Notice clarifies that existing bona fide “good reason” definitions may be revised to incorporate the safe harbor or aspects of the safe harbor to increase the likelihood that a good reason trigger will comply with the general definition of good reason under 409A. Nonetheless, the ability to reform a good reason definition is limited to arrangements where there is an already existing “substantial risk of forfeiture” (*e.g.*, a good reason trigger based on a material diminution in compensation or authority). We assume that this would allow an arguably legitimate good reason definition to be strengthened, but would not allow the reformation of a bogus good reason definition. For example, a good reason definition that allows an executive to terminate and collect severance because he or she was privately criticized by the board of directors for the poor financial performance of the company is suspect and could not be reformed, whereas increasing a geographic relocation trigger from 35 miles to 50 miles is very likely permissible.

Correction Program

The Notice also indicates that the IRS anticipates establishing a program to correct unintentional **operational failures** to comply with 409A. The Notice was silent with respect to correcting plan document issues.

Conclusion and Action Items

Because the period for making binding elections and the transition rules has not been extended, the relief provided by the Notice is, at best, limited. Nonetheless, as noted above, if an arrangement contains 409A compliant distribution provisions, in concept, such arrangement may not need to be amended until December 31, 2008. **Regardless, effective January 1, 2008, all 409A-covered arrangements must be operated in full compliance with 409A and the final regulations.** In the end, you should take the following steps toward compliance with 409A:

1. commence an immediate review of compensation arrangements to determine whether there are any 409A implications;
2. determine what steps toward full compliance must be taken by year end; and
3. develop an action plan and timetable for completing those steps.

¹ As noted in prior advisories, 409A dramatically expands the definition of deferred compensation to include arrangements not traditionally viewed as deferred compensation including, among others, severance arrangements, discount stock options, certain reimbursement arrangements and bonuses paid more than two and one half months after the close of the year in which such bonuses are earned.

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If you have any questions concerning the information discussed in this alert or any other employee benefits topic, please contact one of the attorneys listed below or your primary contact with the firm who can direct you to the right person. We would be delighted to work with you.

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