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HIGHLIGHTS OF FINAL 409A DEFERRED COMPENSATION REGULATIONS

December 31, 2007 Amendment Deadline; Favorable Treatment for Stock Option Extensions; Severance Compensation Exceptions; Additional Aggregation Categories

Final regulations on the deferred compensation provisions of Section 409A of the Internal Revenue Code were issued on April 10th by the Treasury Department and the IRS. While the final regulations are effective for taxable years beginning on or after January 1, 2008, they may be relied upon for prior taxable years.

In addition to confirming the December 31, 2007 deadline for amending nonqualified deferred compensation plans for compliance with Section 409A, there are significant changes in the final regulations that provide favorable treatment for:

- Stock options and stock appreciation rights (SARs), including the ability to extend the time period to exercise stock options and SARs following termination of employment
- Severance compensation, including only treating as deferred compensation the amount of severance compensation in excess of the exemption limit, and providing that termination for good reason is considered to be an involuntary termination under certain circumstances
- Additional categories for the required aggregation of deferred compensation plans

This alert letter highlights certain major aspects of the final regulations, which are lengthy and extensive.

DECEMBER 31, 2007 AMENDMENT DEADLINE

Nonqualified deferred compensation plans must be amended by December 31, 2007 to conform to the Section 409A requirements. A plan can consist of more than a single document, including a deferral election and a grant agreement for stock options or SARs.

STOCK OPTIONS AND SARS

Extension of Post-Termination Exercise Period. In an important reversal of the position in the proposed regulations, extending the period to exercise stock options or SARs following termination of employment will not be treated as an additional deferral feature (that would have subjected the options or SARs to immediate and additional tax under Section 409A, retroactive to the original grant date) if the extension is limited to the earlier of the end of the original maximum term of the option or SAR or the tenth anniversary of the original grant date. Similarly, an extension made when the option or SAR is “underwater” (i.e. the exercise or base price is more than the fair market value (FMV) of the employer stock on the date of the extension) will not be subject to Section 409A, regardless of the length of the extension.

Extensions made prior to April 10, 2007 are disregarded in applying these rules.

Note that an extension could result in an additional accounting expense under FAS 123R.

Service Recipient Stock. For options or SARs to be exempt from Section 409A they must be granted at FMV on service recipient stock. The final regulations expand the definition of service recipient stock to include any class of common stock without preferential dividend rights of the employer corporation, regardless of whether the class (or any other class) is publicly traded. The definition also includes common stock of any corporation in the chain of corporations above the employer corporation if the controlling interest requirement is met, but not a subsidiary or “brother/sister” corporation. The controlling interest requirement is ownership by each corporation in the chain of at least 50% in one of the other corporations, but is reduced to at least 20% if there are legitimate business criteria, including certain joint ventures.

Valuation Rules. The final regulations provide more favorable rules relating to the determination of the FMV of service recipient stock of private companies, including the use of reasonable valuation methods (an independent valuation is not required) and certain rebuttable presumptions.

SEVERANCE COMPENSATION

Separation Pay Exception Applies to Amounts up to Dollar Limit. The final regulations continue the Section 409A exception for severance compensation paid on an involuntary separation from service under which:

- The total payments do not exceed two times the employee’s annual compensation (based on the annual rate of pay for the calendar year prior to separation from service, adjusted for any increase in the year of separation) or, if lower, two times the annual limit on compensation that may taken into account under tax-qualified retirement plans for the calendar year of separation from service (the 2007 annual limit is \$225,000; two times that amount is \$450,000); and

- The arrangement requires that all payments be made by the end of the second calendar year following the calendar year in which the employee separates from service.

In a very significant clarification the final regulations provide that if the total payments exceed the limit, only the amount in excess of the limit is treated as deferred compensation subject to Section 409A. As a result, amounts up to the limit can be paid without regard to the 6-month delay for “specified employees” (generally limited to no more than the 50 highest-paid officers) applicable to severance compensation amounts treated as Section 409A deferred compensation that exceed the limit.

Good Reason Treated as Involuntary Separation from Service. For all purposes of the final 409A regulations (including the separation pay and short-term deferral exceptions), voluntary termination of employment by an employee for good reason is treated as an involuntary separation from service. A plan must define good reason as actions that the employer takes that result in material negative changes to the employee, such as duties, conditions under which duties are performed or the employee’s compensation. The final regulations also provide a safe harbor if a plan or agreement specifies that:

- Termination of employment must occur during a pre-determined period not to exceed two years following the existence of one or more specified good reason events;
- The amount, time and form of payment payable upon termination for good reason must be substantially identical to that payable on an actual involuntary separation of service (to the extent that such a right exists);
- The employee must be required to give the employer notice of the good reason event within a period of not more than 90 days; and
- The employer must have a period of at least 30 days to remedy the good reason event.

Reimbursement Arrangements. The final regulations also continue the exception from Section 409A for certain reimbursement arrangements in connection with an involuntary separation from service, provided that they only cover expenses that are incurred before the end of the second calendar year following the calendar year in which involuntary separation from service occurs. The time for paying the reimbursement has been extended to the end of the third calendar year following the calendar year in which involuntary separation from service occurs. The covered reimbursement arrangements include moving expenses, outplacement expenses and taxable reimbursements of medical expenses. The exception can be relied upon for the specified time periods even if the right to reimbursements or the payments continue beyond the end of the applicable periods.

Tax Gross-up Payments. Although the right to a tax gross-up payment (including for the golden parachute excise tax) is treated as deferred compensation, the final regulations provide that it satisfies Section 409A requirements if it provides that payment must be made by the end of the employee’s taxable year following the taxable year in which the tax payments are made to the applicable Federal, state, local or foreign government.

ADDITIONAL CATEGORIES FOR PLAN AGGREGATION RULES

More categories of deferred compensation plans and arrangements have been added for purposes of the plan aggregation rules; there are a total of nine categories under the final regulations. Certain 409A rules, such as the timing of deferral elections on initial eligibility, require the aggregation of all plans of the same category. Among the new categories added by the final regulations are reimbursement arrangements, account balance plans providing for participant elections and non-elective account balance plans.

This letter is intended to alert compensation professionals about developments that may affect their companies, and should not be considered or relied upon as legal advice. Specific questions about the applicability of Section 409A to compensation plans and arrangements should be discussed with appropriate counsel. General questions applicable to Section 409A may be directed to Richard Alpern in our New York offices at 212-299-3599 or by email at ralpern@fwcook.com. Copies of this letter and other published materials relating to Section 409A are available on our website, www.fwcook.com, under the following links:

<u>Date</u>	<u>Title</u>	<u>Website Link</u>
October 12, 2004	Heads-Up on Deferred Compensation Legislation	http://www.fwcook.com/alert_letters/10-12-04_Heads-Up_on_Deferred_Compensation....pdf
December 2, 2004	Provisions Affecting Deferred Compensation in the American Jobs Creation Act of 2004	http://www.fwcook.com/alert_letters/12-2-04_Provisions_Affecting_Deferred_Compensation.pdf
December 22, 2004	Heads-Up On Deferred Compensation Guidance	http://www.fwcook.com/alert_letters/12-22-04_Heads-Up_on_Deferred_Compensation_Guidance.pdf
February 28, 2005	Action Items in Response to IRS Guidance on Deferred Compensation	http://www.fwcook.com/alert_letters/2-28-05_Action_Items_In_Reponse_to_IRS_Guidance_On....pdf
October 7, 2005	Heads-Up On Deferred Compensation Guidance	http://www.fwcook.com/alert_letters/10-7-05_Heads-Up_On_Deferred_Compensation_Guidance.pdf
November 3, 2005	Year End Action on Deferred Compensation	http://www.fwcook.com/alert_letters/11-3-05_Year-End-Action-on-Deferred-Compensation.pdf
October 11, 2006	Heads-Up On Deferred Compensation Guidance	http://www.fwcook.com/alert_letters/10-11-06_Heads-Up-On-Deferred-Compensation-Guidance.pdf