

New US deferred compensation guidance impacts corporate transactions

BY MARJORIE M. GLOVER

In a continuing effort to curb perceived abuses in compensation for US executives, last year, the US Congress enacted the American Jobs Creation Act. The Jobs Act made some of the most sweeping changes to the law governing deferred compensation in US history. The new law has a significant impact on virtually all US companies, many multinational companies and many corporate transactions.

The new law is very broad in scope. It applies to companies of all forms and sizes (including US and multinational and public and private companies), a wide range of individuals (employees, directors and some consultants) and a wide range of arrangements (including, for example, certain equity-based plans, bonus plans, multinational arrangements and employment, consulting, change of control and severance agreements).

The new law was codified in a new Section 409A of the US Internal Revenue Code and became effective 1 January 2005. 409A imposes strict new rules on payments and deferral elections for deferred compensation and prohibits acceleration of benefits and funding of benefits through offshore trusts and certain other trusts. If the new rules are not followed, 409A imposes severe tax consequences (20 percent penalty, income tax on vesting and interest) on plan participants.

Although the new law became effective 1 January 2005, until recently, companies were left with very little guidance on how to comply with the new law or how the new law impacts corporate transactions. In October 2005, the US Treasury Department and US Internal Revenue Service issued long-awaited comprehensive guidance on 409A.

The new guidance provides generally favourable rules that impact corporate transactions, including rules that allow companies to substitute and cash-out options and SARs, structure certain earn-out arrangements, terminate deferred compensation arrangements and pay out severance in connection with certain corporate transactions without violating 409A.

Good news for equity arrangements generally

When 409A was enacted last year, it was unclear how the new law would impact equity-based arrangements. This was a particular

concern of many companies because, unless the equity-based arrangement is exempt from 409A, the arrangement must comply with the strict new rules of 409A, including providing a fixed exercise or payment date. If the new rules are not followed, the stock recipient is subject to adverse tax consequences under 409A, including a 20 percent penalty tax and immediate taxation on vesting. The new guidance makes clear that non-discount stock options, non-discount stock appreciation rights (SARs) and restricted stock are generally exempt from 409A¹, while other forms of equity compensation such as restricted stock units and performance share awards may be subject to 409A. In an effort to address concerns related to global equity plans, the new guidance makes clear that the exemptions for stock options and SARs extends to stock traded on certain foreign exchanges and to American Depositary Receipts. The new guidance also provides favourable rules for public companies (but only limited relief for private companies) in determining whether the stock option or SAR is 'non-discount'.

Good news for equity arrangements and earn-outs in connection with certain corporate transactions

More good news – the new guidance makes clear that certain substitutions and adjustments of stock options and SARs in connection with certain corporate transactions will not cause an otherwise exempt stock option or SAR to become subject to 409A, as long as the substitution or adjustment is made in accordance with rules similar to (and in some cases even more favourable than) the rules for substituting or adjusting 'incentive stock options' under US tax law. (This test involves maintaining certain 'spread' and 'ratio' tests). The new guidance also exempts 'earn-outs' from 409A, as long as the earn-out is paid on the same schedule and on the same terms and conditions as payments are made to shareholders generally and the amount is paid out fully within five years after the change of control. The bad news is that these favourable rules for substituting and adjusting stock options and SARs and for exempting certain earn-outs apply only if the corporate transaction meets 409A's rather limited definition of a change of control.

Good news for plan terminations in connection with corporate transactions

409A imposes strict limits on when deferred compensation arrangements may be terminated. In response to numerous comments from the business community, the new guidance allows companies to terminate arrangements subject to 409A following a change of control as long as the arrangement (and all substantially similar arrangements) are terminated within 12 months following the change of control. This exception applies only to arrangements terminated in connection with a change of control as defined under 409A.

Mixed news for separation pay arrangements in connection with corporate transactions

The new guidance makes clear that separation pay is generally subject to 409A, but provides several exemptions that are useful for all but the most senior executives. These exemptions include, for example, exemptions for separation pay of up to \$440,000 payable within two years of an involuntary termination of employment and for reimbursement of certain expenses such as outplacement expenses. Although these exemptions are somewhat limited, they should enable companies to structure separation pay arrangements for rank and file employees and lower to mid-level executives without running afoul of 409A. However, change of control and other severance arrangements for more senior executives must comply with 409.

This article highlights only a few of the many complex issues that companies must now face in light of the new US deferred compensation law. Companies are advised to seek the assistance of advisers familiar with 409A before proceeding with any corporate transaction that involves US employees or operations. ■

¹ The exemption for stock options and SARs applies only if the exercise price may never be less than the fair market value of the stock on the date of grant and only if the option or SAR contains no deferral feature other than the right to exercise in the future. The exemption applies only to "service recipient" common stock and only if certain valuation requirements are met.

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