

D&G Legal Development Alert: Executive Compensation & Employee Benefits

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SPECIFIED EMPLOYEES UNDER SECTION 409A

Internal Revenue Code Section 409A requires that any deferred compensation paid to a “specified employee” of a public company on account of his or her separation from service must be delayed for six months following the separation. This requirement is known as the “six-month delay rule.”

Noncompliance with Section 409A results in very significant penalties to affected employees. Accordingly, it is very important for both US public companies and foreign public companies with US affiliates to identify their specified employees in order to comply with the six-month delay rule. A definitive strategy for identifying specified employees must be in place by no later than December 31, 2008.

Public Company Status

The six-month delay rule applies only to a specified employee of a public company. A company is considered to be a “public company” under the final regulations if its stock is traded on an “established securities market” which generally includes:

- National securities exchanges registered under Section 6 of the Securities Exchange Act of 1934 (e.g., the New York and American Stock Exchanges);
- Foreign national securities exchanges that are officially recognized, sanctioned or supervised by a governmental authority (e.g, the London and Canadian Stock Exchanges); and
- Over-the-counter markets reflected by an interdealer quotation system (e.g., Nasdaq).

Under the final regulations, subsidiaries and affiliates of a public company are treated as if they were public companies. Therefore, the six-month delay rule may apply to an employee of a US subsidiary or affiliate of a foreign public company.

Defining Specified Employees

The final regulations provide guidance regarding how a public company identifies its specified employees. Regarding certain issues, a public company has the discretion to make “elections” that are different from the “default” rules provided by the regulations.

Generally, a “specified employee” is any employee of a public company who satisfies any of the following conditions:

- Any five percent owner of the public company;
- Any 1 percent owner of the public company with annual compensation of more than \$150,000; or
- Any officer of the public company with annual compensation of more than \$150,000 (as adjusted), but limited to a number of employees equal to the lesser of (a) 50 employees, or (b) the greater of (i) three employees or (ii) ten percent of the employees.

Compensation for purposes of the above is defined by reference to the definition of compensation found under Treasury Regulation Section 1.415(c)-2(a) but without the safe harbors and special timing rules permitted by that Section. However, employers are permitted to elect to use any definition of compensation permitted by Section 415 of the Internal Revenue Code (including safe harbors and special timing rules) so long as that definition is used consistently by all related employers for purposes of identifying specified employees.

Based on the foregoing, the following alternative definitions of compensation may be used for purposes of identifying specified employees:

- W-2 Box 1;
- Wages for purpose of federal income tax withholding; or
- Compensation defined under Section 415(c)(3) of the Internal Revenue Code.

Each of these definitions is slightly different. For example, using Box 1 of W-2 may be attractive because of its simplicity, but such definition includes income due to restricted stock vesting and nonqualified stock option exercises which can create significant changes in year-to-year compensation levels.

The limit on the number of officers that an employer may count as specified employees described above is based on the number of employees within the employer's controlled group of companies. Where the number of a controlled group's officers exceeds the applicable limit, the officers with the greatest compensation during the 12-month period ending on the "specified employee identification date" (described below) will be deemed specified employees. For example, if a controlled group of companies has more than 500 employees, not more than 50 officers will be considered as specified employees. The 50 who are considered specified employees will be those within the controlled group who have the greatest compensation during the 12-month period ending on the specified employee identification date.

Make A List

The final regulations essentially require a company to create a list of their specified employees that will be in effect for a 12-month period. If an employee separates from service during the 12-month period, the employer would refer to the list to determine whether the employee is subject to the six-month delay rule.

In order to create the list, the employer must select a "specified employee identification date" and a "specified employee effective date." Under the final regulations, an employee who satisfies any of the conditions described above at any time during the 12-month period ending on the specified employee identification date will be considered a specified employee for the 12-month period beginning on the "specified employee effective date."

The "default" specified employee identification date under the final regulations is December 31st and the "default" specified employee effective date is the following April 1st, although the rules allow an employer to elect a different identification date and effective date within certain parameters.

If the employer does not make any special election and the default rules apply, any employee who satisfies the conditions described above at any time during the 12-month period ending December 31st would be considered a specified employee for the 12-month period beginning on the following April 1st.

Special rules apply for determining specified employees in the case of spin-offs, mergers and acquisitions.

Foreign Affiliates

A multinational company having employees in both the US and in foreign countries has the ability to decide whether its foreign employees are counted as specified employees. It may do so by electing a definition of compensation that results in either more or fewer foreign employees satisfying the conditions for specified employee status.

As described above, the final regulations provide a default definition of compensation for determining specified employee status. Under that default definition, compensation includes any income that would normally be excludible from an employee's gross income due to the location of the employer or the services provided being outside the US ("foreign income"). However, an alternate definition of compensation would permit the employer to exclude foreign income from the definition of compensation, if the employer so elects.

Although it depends on certain factors, if an employer uses the default definition of compensation for determining specified employee status it will usually increase the number of its foreign employees being deemed specified employees. Therefore, the number of its US employees deemed specified employees (and the number subject to the six-month delay rule) would decrease.

For example, if an employer ranks its officers by compensation and includes foreign income in the definition of compensation, the result will likely be the inclusion of a number of officers outside the US on the list of specified employees. However, if foreign income is excluded from the definition of compensation, it is likely that no officers outside the US will have compensation high enough to place them within the group of top 50 officers based on compensation.

A multinational company should consider carefully the impact that its choice of compensation definition will have on its list of specified employees. Although including foreign income will likely

reduce the number of employees subject to the six-month delay rule, doing so will only be practicable if the company can identify its foreign officers and how much they earn without excessive administrative burden. Fitting foreign compensation data into the US tax code definitions and converting the foreign compensation into US currency pose additional hurdles.

Alternative Method of Compliance

Under the final regulations, an employer is permitted to elect an alternative method for determining specified employees, provided that:

- The method is reasonably designed to ensure that all specified employees (as determined without any special elections by the employer) are identified;
- The method is an objectively determinable standard, providing no election to any employee with respect to its application; and
- The method results in either all employees or no more than 200 specified employees being identified as of any date.

For example, to ease administrative burden, an employer may determine that all employees in certain pay grades or who have certain titles will be deemed specified employees.

Final Thoughts

Identifying an employer's specified employees is only half the battle. Prior to January 1, 2009, applicable nonqualified deferred compensation arrangements, including employment agreements and severance plans, must be amended to reflect the six-month delay rule. In addition, a company that makes one or more of the special elections available under the final regulations must take appropriate action so that those elections are legally binding on participants.

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