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Re: Separation From Service and the 6-Month Delay Rule Under Code §409A

Dear Clients and Other Friends:

In this letter we look more closely at the Code §409A final regulations' definition of "separation from service" to see how that definition affects when deferred compensation is paid, and to identify changes that can be made to the definition in order to alter the regulations' default rules.

After discussing separation from service, we then address the 6-month distribution delay that must be imposed when a publicly-traded company distributes deferred compensation to a "specified employee" on account of a separation from service. As with separation from service, the final regulations offer a default definition but then allow changes that can alter the result.

I. Separation from Service

Under the final regulations an employee has a separation from service when the facts and circumstances indicate that the employee's reasonably anticipated level of future services will be 20% or less than the average level of services over the immediately preceding 36-month period (or the full period of service if that is less than 36 months).¹ Strictly speaking, this test is objective because the result depends on inferences to be drawn from the facts and circumstances and not on the parties' subjective intent. It is difficult to administer, though, because it requires a judgment call about what intent should be inferred from the facts and circumstances.

To address this problem and make the test a little more user-friendly, the regulations establish rebuttable presumptions about the parties' initial intent based on the level of services subsequently provided by the employee. Specifically, if an employee provides services at 20% or less of the employee's average level of services over the preceding 36-month period, the employee is presumed to have had a separation from service. If services are provided at 50% or more of the employee's 36-month average level, the employee is presumed not to have separated from service. Service provided at a rate between those thresholds creates no presumption.

In most cases, the outcome of this complicated scheme will follow common sense. A full-time employee who retires and immediately ceases all services to the employer obviously

¹ The definition of separation from service for independent contractors does not use this 20% standard. An independent contractor has a separation from service only if there is a good-faith and complete termination of the contractual relationship. Such a termination will not occur if the contractor anticipates a renewal of the relationship or to be employed by the service recipient. A plan may satisfy this requirement by providing that payment will be delayed until at least 12 months after contract expiration and suspended if services resume before the commencement date.

falls below the 20% threshold and has separated from service. Reduced service, leaves of absence, business transactions and other special situations, however, can lead to less predictable results.

A. Reduced Services. The running 36-month service average coupled with the precise 20% threshold may make it difficult for employers to recognize when a separation from service has, or has not, occurred in borderline situations. Plan administrators may miscalculate the average past service or simply be unaware of changes in an employee's work schedule. If services have actually dropped below the 20% threshold, there may be little objective evidence to rebut the presumption of separation. In other situations, a plan administrator may think that a separation has occurred based on work schedule changes, only to later find that the circumstances do not support a separation.

Uncertainty about the effect of service reductions cannot be eliminated by simply having the reduced services performed as an independent contractor. Under the final regulations, the same 20% threshold applies to employee deferred compensation regardless of whether the future services are performed as an employee or as an independent contractor. As a result, employers who want departing executives to continue performing significant consulting services will need to have a clear understanding of the amount of services that will be provided – regardless of whether those services are performed as an employee or independent contractor – in order to gauge the effect of those services on the distribution of deferred compensation.

B. Leaves of Absence. The regulations provide that no separation from service will be deemed to occur during a “bona fide leave of absence” if the leave is no longer than six months or the employee retains a right to reemployment under an applicable statute or by contract. For example, employees on military leave will not have a separation from service so long as they return to work before their reemployment rights expire.

For a leave to be “bona fide”, there must be a reasonable expectation that the employee will return to work for the employer. This requirement will be troublesome for employers that put departing employees on a leave of absence in order to allow them to age into other benefits. While the individual on leave may still be treated as an employee for other benefits, the leave will not prevent a separation from service from occurring that triggers distribution of deferred compensation.

The leave rule may also result in an inadvertent separation from service in some common leave situations. For example, if an employee is given a bona fide 6-month leave and that leave is extended without reemployment rights, the final regulations will treat a separation from service as occurring at the end of the original six months.

Finally, whether an employee has had a bona fide leave of absence may also affect calculation of the 36-month service average used in applying the rebuttable presumption. Bona fide paid leave is treated as time worked at the rate necessary to earn the amount paid. Bona fide unpaid leave is disregarded in setting the 36-month average. If an unpaid leave of absence turns out not to be “bona fide”, it will be treated as part of the 36-month period, reduce the 36-month average, and increase the risk of an inadvertent separation.

C. Board Service. Generally, if an employee also provides services as an independent contractor as well as an employee, the employee must separate from both the employee and the contractor service to trigger a distribution. A special rule for employee-directors, however allows the director service to be disregarded for purposes of employee deferred compensation, and the employee service to be disregarded for purposes of the director deferred compensation, so long as the employee and director plans do not have to be aggregated for §409A purposes.

D. Definition of Employer. The final regulations by default define the employer as the actual service recipient and all other entities that would be treated as a single employer using the rules applicable to qualified plans, but applying a 50% ownership or control standard instead of the usual 80%. When an employer transfers between affiliated entities, then, it will be important to know how those entities are related. Under the default rules, transfer to a 49% owned affiliate would trigger a separation, but transfer to a 51% owned affiliate would not.

II. Permitted Modifications to Definition of Separation

The Treasury and IRS intentionally declined to allow employers the freedom to fully customize the definition of separation from service, arguing that Code §409A requires a predictable, nondiscretionary and nonnegotiable definition. Nevertheless, the final regulations do allow employers a few opportunities to alter the default rules described above:

- *Definition of Employer* – The most useful modification allowed by the rules may be the ability to change the 50% ownership standard that defines when a transferring employee has left the employer and must receive a distribution. A plan can increase the standard to as much as 80% for any reason. Alternatively, if there is a legitimate business reason, a plan can lower the standard to a little as 20%. Lowering the threshold will allow employers who are 20% or more participants in a joint venture to transfer employees to the venture without triggering distributions on account of separation from service. In either case, the alternative definition will have to be fixed in writing by the deadline for setting the deferred compensation payment terms. (For plans already in existence, the deadline is December 31, 2007.) Any subsequent change will only be allowed if the rules governing subsequent changes (which mandate a minimum five-year delay) are followed.
- *Asset Purchase Transactions* – A separation from service that would otherwise be caused by certain asset purchase transactions can be avoided by agreement of the seller and buyer. This limited right to negotiate the outcome exists only if the transaction is a bona fide arm's length negotiation by unrelated entities, the transaction constitutes a transfer of substantial assets (such as a plant or division), all similarly situated employees of the seller are treated consistently, and the negotiated terms are specified in writing no later than the closing date of the transaction. For example, if an employer sells a division, it might agree with the buyer that deferred compensation balances for employees at that division will not be distributed until the employees separate from service with the buyer.
- *Service Threshold* – The 20% of prior average service threshold that determines whether a separation from service has occurred can be increased to as much as 50%. Since a higher threshold makes distribution more likely, this alternative may be seldom used. If it is used, the higher threshold must be set by the deadline for setting the other deferred

compensation payment terms, and any changes will only be allowed if the rules governing subsequent changes (five-year delay required) are followed.

- *Leave of Absence Due to Disability* – The deemed separation from service that occurs after six months of bona fide leave of absence without reemployment rights may be delayed until the end of 29 months of leave if the leave of absence is for disability.

III. Specified Employees

While privately held employers may pay deferred compensation immediately upon separation from service, publicly held employers must delay payment to “specified employees” for at least six months, unless the deferred compensation qualifies for an exemption such as the exemption for severance pay described in our last letter.

The definition of specified employee begins with the definition of “key employee” in Code §416(i)(1) that is familiar to sponsors of tax-qualified plans. It includes:

- Up to 50 officers with annual compensation over a dollar threshold (\$145,000 for 2007);
- 5-percent owners; and
- 1-percent owners with annual compensation over a dollar threshold (\$150,000).

By default, compensation is defined using the basic definition in the regulations under Code §415, without regard to safe harbors, special timing rules and other special rules.

In order to allow employers to know with certainty which employees are specified employees, the regulations adopt a two-step determination procedure. First, key employee status is determined as of a specified date, known as the “specified employee identification date”. By default, this date is December 31. Second, the list of specified employees as of that date is used during the 12-month period that starts by default on the first day of the fourth month after the specified employee identification date (i.e., the following April 1). The starting date is referred to as the “specified employee effective date”. An employee who is a key employee on the specified employee identification date is considered a specified employee throughout the 12-month period starting on the next specified employee effective date, regardless of changes in pay or status during the 12-month period.

The final regulations also give specific default rules for handling the determination of key employee status in a variety of corporate transactions. For example, when public companies merge, the list of specified employees is determined by combining the officer lists of the merging companies, ranking the top 50 by compensation, and using that top 50 (plus the 1-percent and 5-percent owners) until the next specified employee effective date of the acquiring or surviving corporation. If a nonpublic entity merges with a public entity, the specified employee identification date and effective date of the public entity is used for the post-transaction entity. Until the first effective date after the transaction, the specified employee list of the pre-transaction public entity controls, and none of the private entity employees are required to be treated as specified employees. In the event of a spinoff, the resulting entities continue to have the same identification and effective date as the pre-transaction entity, and the employees on the

pre-transaction list are the only specified employees until the first specified employee effective date after the transaction.

IV. Permitted Modifications to the Definition of Specified Employee

As in the case of the definition of separation from service, the definition of specified employee offers some significant opportunities to change the default definition. Changes to the definition of specified employee, however, cannot be made piecemeal; they must be made legally binding and applicable to all employees. Any change to the definition may not be made effective for at least 12 months.

- *Identification Date* – An employer may choose any date during the year as the specified employee identification date.
- *Effective Date* – An employer may choose any date after the specified employee identification date that is earlier than the default date.
- *Compensation* – An employer may specify any available definition of compensation under Code §415 for the purpose of identifying specified employees.
- *Alternative Methods* – The regulations allow employers to use alternative, overinclusive methods to identify specified employees who will be subject to the six-month delay, provided the alternative method is reasonably designed to include all individuals who would be specified employees under the default identification methods, the method uses objectively determinable standards (no employee elections), and the end result produces a list that either includes all employees or no more than 200 employees.
- *Mergers and Acquisitions* – In lieu of the default rule, the final regulations allow the surviving employer in a transaction involving more than one public employer to elect “any reasonable method” to determine specified employees, if the method is adopted no later than 90 days after the transaction and applied prospectively from the adoption date.
- *Initial Public Offerings and Certain Other Transactions* – In the case of initial public offerings and certain other transactions for which there is no other rule, the post-transaction employer can elect an identification date and effective date before the transaction that is used to determine specified employees from the date of the transaction.

V. Practical Difficulties in Identifying Specified Employees.

Identifying specified employees will be a particular challenge for employers that are decentralized and do not have a unified payroll system. Exactly who is a specified employee in such situations will depend on whether the individual is one of the highest paid officers of the employer as a whole rather than on status within the individual’s business group or division. In order to make a precise determination of the specified employee list, the employer will have to combine payroll data from all available payroll systems.

Another difficulty relates to multi-national employers. Certain overseas employees are relevant in determining the specified employee list,² even though exact pay data for such employees may be difficult for the U.S. employer to obtain.

Some of these difficulties can be avoided if the employer simply provides that all employees will be subject to the 6-month hold back following separation from service, regardless of whether they are specified employees. If the plans are designed that way, it will not be necessary for the employer to ever have to determine exactly who would be on the specified employee list.

Employers that wish to take advantage of the flexibility offered by the alternative provisions in these rules will want to quickly assess which rules best suit their needs. During the current transition period (scheduled to end on December 31st of this year), employers will have considerable flexibility to change the rules for deferred compensation already earned. In the future changes will be more difficult and in some circumstances they may be a practical impossibility. For this reason, it is especially important to consider these matters as soon as possible.

As always, if you would like to discuss these rules further or consider how they might apply in the context of your plans, please let us know.

Sincerely,

John W. Haine

JWH/ram

² Non-resident aliens working abroad generally can be excluded for purposes of identifying specified employees.