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Client Alert

An informational newsletter from Goodwin Procter LLP

Section 409A Requires Action on Portfolio Company Executive Arrangements

Introduction

As described in our October 2004, December 2004, October 2005 and May 2007 Client Alerts, the American Jobs Creation Act of 2004 added Section 409A to the Internal Revenue Code. Section 409A substantially changed the federal income tax treatment of non-qualified deferred compensation ("NQDC") arrangements maintained by employers and other entities that receive services from employees, partners, directors and other individuals. Failure to comply with the new requirements will result in early taxation of NQDC, as well as a 20% penalty tax and additional interest payable to the IRS. These rules generally became effective January 1, 2005, and require documentary compliance by December 31, 2008.

Much of the preliminary guidance issued under Section 409A emphasized the application of Section 409A to equity-based arrangements. As a result, many portfolio companies changed their equity granting practices in order to avoid Section 409A penalties, often at the urging of private equity and venture capital fund investors. It is important to note, however, that the scope of Section 409A extends beyond equity-based arrangements. The employment, severance, change in control and other similar agreements and arrangements in place between a portfolio company and its executives and employees (collectively, "Executive Agreements") may also be subject to Section 409A and may need to be amended before December 31, 2008 to avoid negative tax consequences.

Separation Pay and Other Severance Arrangements

Executive Agreements that provide for the payment of severance upon termination of employment may be subject to the requirements of Section 409A as severance is generally considered to be deferred compensation subject to Section 409A. However, there are two notable exceptions pursuant to which severance payments will not be subject to Section 409A:

- Severance pay that is payable only in the event of an "involuntary" termination (which may in some cases include termination for good reason) can be structured to meet the short-term deferral exception to the definition of NQDC, meaning that the severance must be paid within two and one-half months after the end of the year in which termination of employment occurs (*i.e.*, the year in which the severance payment vests).

- Severance pay that is payable *only* in the event of "involuntary" termination (which may in some cases include termination for good reason) is not subject to Section 409A *to the extent* it does not exceed the lesser of (i) two times last year's compensation or (ii) two times the IRS limit for qualified plans (currently $230,000), as long as it is paid by no later than December 31 of the second calendar year following the calendar year in which the termination occurs. If severance pay exceeds this limit, only the excess will be considered deferred compensation.

Whether a termination for good reason is considered an "involuntary" termination for purposes of the exceptions described above is determined based on the facts and circumstances of the particular situation. In this regard, the applicable 409A guidance does provide a safe harbor definition of good reason which includes a material diminution in responsibilities, material reduction in base pay, relocation, etc., as well as a mandatory cure period.

If payments or benefits under an Executive Agreement do not fall within an applicable exception (described above), then the terms of the arrangement may need to be amended to comply with Section 409A in order to avoid negative tax consequences, and such amendments must be made by December 31, 2008. Generally, to comply with the requirements of Section 409A in this regard:

- The timing and form of payment (with respect to severance, benefit continuation and/or expense reimbursement) under the Executive Agreement needs to be fixed in advance.

- Once fixed, the timing and form of payment under the Executive Agreement generally cannot be modified (*e.g.*, it cannot be changed or renegotiated at the time of an individual's termination of employment).

- Additional requirements will apply in the event the portfolio company is or becomes a public company. For example, severance payable to the top 50 highest paid officers of a public company is generally subject to a six-month delay.

For more detailed information regarding the application of Section 409A to severance payments, please see our May 2007 Client Alert, "Final Section 409A Regulations and Severance Pay."

Specific Action Items for 2008

Fund investors should encourage their portfolio companies to:

- Review all compensatory arrangements, including all employment, change in control, severance and other similar agreement and arrangements, to determine whether there are NQDC arrangements subject to Section 409A.

- Amend arrangements subject to Section 409A to become compliant with the requirements of Section 409A, or amend such arrangements in a manner so

that they are clearly not subject to Section 409A (*e.g.*, by falling within an applicable exception), in either case, before December 31, 2008.

If you would like additional information about the issues addressed in this client alert, or have other questions regarding benefit plans or executive compensation, please contact:

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