2010 Year-End Executive Compensation Matters: Section 409A, Stock Plan Transaction Tax Reporting and Return Filing Requirements, COBRA Reimbursement Benefits, and Tax Rate Change Matters

This Alert highlights certain compensation tax and benefits matters that clients should consider as we approach the end of 2010.

Deferred Compensation Tax/Section 409A Matters: New issues and concerns under Section 409A, the federal deferred compensation tax statute, arose this year, including as a result of the IRS's release of a corrections program notice early in the year which implied concerns where none had previously been thought to exist. This is very frustrating, given the substantial amount of time spent reviewing compensation arrangements when the original Section 409A compliance period ended in 2008. The good news, though, is that Notice 2010-6 allows certain documentary errors to be corrected by December 31, 2010 without penalty. An earlier corrections program continues to be available under which certain operational problems can be corrected within specified periods after they occur. In addition, in some cases there may be flexibility under IRS proposed income inclusion regulations to correct arrangements prior to the year in which the service provider vests in the arrangement.

Because the periods within which action must be taken under each of these approaches are limited, and because Notice 2010-6 allows for certain document corrections without penalty only if undertaken before the end of 2010, **public and private company clients** should consider having arrangements with Section 409A implications reviewed and, if appropriate, corrected before year end. After this year, we expect that it will be more burdensome to make the some of the same corrections, including because the service provider may be required to pay additional taxes if certain events occur during specified periods following correction.

In general we would not expect a current review to result in a lot of changes to existing arrangements, nor would we expect in most cases that changes determined necessary would be particularly material to the basic business terms of the arrangements. Recognizing that there is a fairly high level of Section 409A fatigue at this point, we nonetheless believe clients should have certain arrangements reviewed before this current compliance window closes, even if the arrangements were previously reviewed or put into place recently, as the results of noncompliance under Section 409A are steep -- 20% additional federal tax, additional taxes imposed by some states (California, for example, imposes an additional 20% tax), and interest charges.

The types of arrangements that we are reviewing for clients, and the issues that have surfaced this year, include the following:

- Agreements (including offer letters) that provide for cash and certain other severance benefits where payment/receipt of such benefits is conditioned on the employee's delivering a release of claims or noncompetition agreement. The specific concern applies to agreements under which payment timing ties to the post-termination effective date of a release or other agreement where it is possible for the employee to control the timing of such effectiveness by choosing when to deliver the executed agreement. Because the window of time within which the employee may deliver the release/agreement could span two tax years if the separation occurs late in year 1, the concern arises because the employee could choose the year of payment by strategically timing delivery of the executed release/agreement. A common structure, now potentially problematic under the latest IRS guidance, has been to require that a release be delivered within a specified number of days (e.g. 60 days) following the employment termination date, with payment made or commencing on a fixed number of days after the release becomes effective.

> We are working with clients either to amend individual arrangements of this sort to specify a fixed payment date (e.g., on the 65th day following the separation date) or to establish as a matter of corporate policy that, in the event the window within which the release or agreement must be delivered spans two tax years, the company will in all cases make payment in year 2.

- Severance arrangements that allow parties to choose between, or that otherwise provide for, alternative payment schedules or structures based on a single triggering event (e.g., an arrangement that contemplates both lump sum and installment payments) should also be reviewed to determine whether corrective action is appropriate.

- Transaction bonus or "carve-out" plans that pay bonuses on and, often also, following a change in control, in particular if the company anticipates a change in control transaction during the course of 2011. We are looking closely at plans of this sort if they provide for payments to be made after the closing of the change in control to assess whether the structure is likely to raise Section 409A questions in the course of the transaction.

- Restricted stock units, if they provide for accelerated vesting or could be deemed to be vested (e.g., where the award is treated as vested once the holder reaches retirement age), where the shares are or could be issued outside of the short-term deferral period (two and a half month after the end of the applicable tax year).

- Stock options as to which any concerns have arisen either with regard to whether the exercise price is at least equal to the grant date fair market value or the stock underlying the option qualifies as "service recipient stock" (generally, issuer common stock). These issues generally arise only with respect to stock options issued by private companies.

- Any of the above arrangements, or other arrangements designed comply with or be exempt from Section 409A, to ensure that they include, if required, permitted payment events (fixed date, change in control, separation from service, disability or death) and compliant definitions (e.g., separation from service, disability, change in control, involuntary termination).

- Arrangements involving public company officers that pay on a separation of service, including severance arrangements, to ensure that the arrangements include a six-month delay in payment (required under certain circumstances).

- Arrangements that include reimbursements, in-kind benefits, post-termination health coverage benefits (but see below) and golden parachute tax "cutbacks," in particular to make sure that the timing of payment provisions conform to the Section 409A requirements.

- So-called "salary deferral" programs, including arrangements favored by some private companies that pay founders little or no cash compensation in the initial start-up phase of the company, as these arrangements are typically difficult to structure in a way that both satisfies the parties' business desires and conform with the Section 409A requirements.

Year-end reporting of incentive stock option exercises and transfers of stock acquired under Section 423 purchase plans. With respect to calendar year 2010, **public and private companies** are required for the first time to file information returns (on Form 3921) with the IRS reporting all incentive stock option exercises during the year. In addition, companies (typically relevant only for **public companies**) are now required to file information returns (on Form 3922) with the IRS reporting initial transfers of shares of stock acquired under an employee stock purchase plan during the 2010 calendar year. Employers must file these forms with the IRS no later than February 28, 2011, if filing paper returns, or March 31, 2011, if filing electronically. Companies reporting 250 or more transactions are required to file electronically and companies may voluntarily file electronically.[1] Note that because each exercise or transfer triggers a separate form, each such transaction, even if effected by the same individual, triggers an additional reporting/filing requirement. The final Forms 3921 and 3922 will be made available by the IRS later this year, and will replace previously published draft forms.

Certain third-party vendors, for example Stock & Option Solutions at www.sos-team.com, are available to assist companies with preparing and filing Forms 3921 and 3922. For additional vendors, please see the IRS website at www.irs.ustreas.gov/pub/irs-pdf/p1582.pdf or contact Gunderson Dettmer.

Despite the later deadlines for filing the information returns with the IRS, information statements (previously sometimes referred to as 6039 forms) must still be furnished to employees and former employees by January 31, 2011. Employers may satisfy this requirement by delivering "Copy B" of the applicable form. Alternatively, companies may use substitute forms for the employee information statements, as long as the substitute forms meet published IRS guidance as to form and content.

The penalties for late filing or failure to file information statements to employees and information returns with the IRS could be substantial including as a result of the recently enacted Small Business Jobs Act of 2010, under which the penalties for late filing is between $60 - $100 per form with maximum penalties of up $1.5 million and penalties for intentional disregard of these requirements is $250 per form with no maximum.

Employer payment of COBRA premiums for terminated highly-compensated employees may result in penalties under new healthcare law. Payment or reimbursement of a terminated employee's COBRA premiums following the end of employment is a fairly common feature of many severance arrangements for both **public and private companies**, including because under healthcare plans typically used by our clients this benefit was not taxable to the former employee. Changes effected by the recent healthcare legislation, the Patient Protection and Affordable Care Act, may require a change in practice with respect to this benefit. It appears that under the new law an employer's paying or reimbursing COBRA premium costs for a highly-compensated individual could cause an insured healthcare plan (as opposed to a self-funded or self-insured plan) under which the former employee is covered to fail the nondiscrimination testing requirements if this benefit is offered to highly-compensated individuals and not to non-highly-compensated individuals. Generally the most highly compensated 25% of the workforce are considered to be highly-compensated individuals. The new law appears to impose a cash penalty on companies whose plans fail the discrimination requirements for this reason.

Many interpretive questions as to the consequences of offering these benefits remain as of the date of this Alert. This nondiscrimination requirement has historically applied to self-funded healthcare plans and we anticipate similarities between the self-funded plan rules and the rules that will apply to insured plans; regulations are expected to be issued in 2011. Insured plans in operation as of March 23, 2010 are generally exempt ("grandfathered") from the new law, although plans currently grandfathered will likely lose that status over time as changes are made to benefits, costs of premiums and extent of coverage. A company's healthcare provider or insurance broker should know whether its plans are grandfathered.

While not requiring action by any particular date, employers with arrangements of this sort in place, including arrangements that promise these benefits in the event of future employment termination, should discuss this issue with their health plan providers and consider having counsel review existing contractual arrangements committing to COBRA

[1] The electronic filings will use the "FIRE" system (Filing Information Returns Electronically) at https://fire.irs.gov/. If a company already files forms like 1099, 1098, or W-2 electronically, it will not need to apply for a new filing code. Otherwise a company must request a Transfer Control Code (TCC) filing code via Form 4419 from the IRS prior to the end of this year and should allow 30 days for this process.

benefits. Going forward, our likely recommendation to clients wanting to assist a former highly-compensated employee with healthcare costs in the period following employment termination will be that they include in severance packages a lump-sum taxable payment (unrestricted as to use of funds) rather than committing to paying or reimbursing COBRA premiums. Alternatively, it should be possible with appropriate Section 409A structuring to retain the basic terms of current arrangements (payment made only in the amount of the COBRA premiums and only for the period during which the former employee is covered by COBRA) but report the payments as taxable income to the former employee.

Tax savings opportunity for purchases of stock. For persons holding rights to purchase stock of, or otherwise having investment opportunities in, private companies, the following unusual tax savings opportunity presents itself:

Potential investors in private companies (including employees holding exercisable options or other rights to purchase stock) should note that an opportunity to exclude 100% of the capital gain and alternative minimum tax upon sale of the stock of a "qualified small business" exists if such stock is purchased before the end of 2010.

The Small Business Jobs Act of 2010 provides this 100% exclusion opportunity only if the qualified small business stock is purchased at original issuance between September 28, 2010 to December 31, 2010 and is held for more than five years. A "qualified small business" is a C corporation engaged in the active conduct of a trade or business with gross assets not exceeding $50 million. The maximum amount of gain that may be excluded by a taxpayer with respect to any corporation is the greater of ten times the taxpayer's basis in the stock or $10 million.

> Update: The 100% exclusion opportunity was extended to cover qualified small business stock acquired before the end of 2011, pursuant to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed by President Obama on December 17, 2010.

Gunderson Dettmer's lawyers are available to assist in addressing questions you may have regarding the issues discussed in this Alert. Please contact the Gunderson Dettmer attorney with whom you regularly work. Contact information for our attorneys can be found at www.gunder.com.