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New York • Chicago • Los Angeles

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HEADS-UP ON DEFERRED COMPENSATION GUIDANCE

New IRS Guidance on Deferred Compensation Provisions of Section 409A – Extension of Plan Amendment Deadline and Other Transition Relief; Treatment of SARs; Fiscal Year Employers; Severance Compensation Exception

On September 29th the Treasury Department and the Internal Revenue Service issued proposed regulations on the deferred compensation provisions of Section 409A of the Internal Revenue Code (IRC).¹ The IRS guidance in Notice 2005-1² generally remains in effect until the effective date for the final regulations when they are issued, except for the extension of certain transition relief. The proposed regulations may be relied upon until the effective date for the final regulations, which is expected to be, in general, for taxable years beginning on or after January 1, 2007.

The proposed regulations extend until December 31, 2006 the deadline for amending nonqualified deferred compensation plans and arrangements to comply with Section 409A, treat all stock appreciation rights (SARs) granted with a fair market value exercise price as not providing for the deferral of compensation, specify rules for the timing of elections to defer compensation for employers with fiscal years other than the calendar year, and provide that severance compensation below a specified amount will not be treated as nonqualified deferred compensation

This alert letter highlights the major aspects of the proposed regulations, which are lengthy and extensive. A subsequent alert letter will discuss the proposed regulations in more detail.

EXTENSION OF DEADLINE TO DECEMBER 31, 2006 FOR AMENDMENTS AND CERTAIN TRANSITION RELIEF

Amendments by December 31, 2006. The deadline for amending nonqualified deferred compensation plans and arrangement for compliance with Section 409A has been extended by one year. Accordingly, a plan or arrangement adopted (or entered into) before December 31,

¹ Refer to our letters dated 10/12/04 and 12/2/04, which are available on our website at http://www.fwcook.com/alert_letters/10-12-04%20Heads-Up%20on%20Deferred%20Compensation....pdf
http://www.fwcook.com/alert_letters/12-2-04_Provisions_Affecting_Deferred_Compensation.pdf

² Refer to our letters dated 12/22/04 and 2/28/05 discussing Notice 2005-1, which are available on our website at http://www.fwcook.com/alert_letters/12-22-04%20Heads-Up%20on%20Deferred%20Compensation%20Guidance.pdf
http://www.fwcook.com/alert_letters/2-28-05%20Action%20Items%20In%20Reponse%20to%20IRS%20Guidance%20On....pdf

2006 must be amended by December 31, 2006 to conform to the requirements of Section 409A. The plan or arrangement must be operated through that date in good faith compliance with Section 409A and the provisions of Notice 2005-1. It is permissible to comply with a provision of the proposed regulations (or the final regulations if issued before December 31, 2006) if it is inconsistent with the Notice.

New Payment Elections. A new payment election of the time or form of payment of amounts subject to Section 409A is generally required to (i) be made at least 12 months prior to the scheduled payment date, (ii) result in a delay of payment for at least 5 years from the scheduled payment date and (iii) not accelerate payment. The proposed regulations extend until December 31, 2006 the date that a new election can be made without being subject to those requirements. The plan or arrangement must be amended by December 31, 2006, to provide for the new elections. However, the new election cannot be made with respect to payments that would otherwise be received in 2006, nor can it result in payments being made in 2006.

Payments Based on Qualified Retirement Plan Election. Payments under supplemental executive retirement plans and excess retirement plans which are determined by payment elections made under a tax-qualified retirement plan can be made or commenced through December 31, 2006 without violating the requirements of Section 409A relating to the timing and form of payment, provided that such determinations are made in accordance with the terms of the plan as of October 3, 2004.

Equity-Based Compensation. See “Replacement or Modification of Discount Stock Options and SARs” below for the extension of transition relief applicable to certain equity-based compensation.

Transition Relief Not Extended. The proposed regulations do not extend the transition relief in Notice 2005-1 with respect to:

- Elections by March 15, 2005 to defer compensation that relates in whole or in part to services performed in 2005
- Elections by participants or employers at any time during 2005 to terminate participation or cancel a deferral election with respect to amounts subject to Section 409A
- Termination of a grandfathered plan or arrangement by December 31, 2005

EQUITY-BASED COMPENSATION

Stock Appreciation Rights. SARs on employer stock with an exercise price of not less than the fair market value (FMV) of the employer’s stock on the date of grant will not be treated as providing for the deferral of compensation, regardless of whether the employer’s stock is publicly traded and whether the SAR is settled in cash or stock. The proposed regulations treat SARs in the same manner as stock options, including the requirement that there not be any feature for the deferral of compensation, other than the right to receive stock or cash upon

exercise of the SAR or option. The amount payable on exercise of the SAR cannot exceed the difference between the FMV of the employer's stock on the date of exercise of the SAR and the FMV of the employer's stock on the date of grant of the SAR.

Valuation Rules. The proposed regulations set forth rules for determining FMV of employer stock, including:

- For publicly traded stock, using the last or first sale after the grant, closing price on the trading day before grant or the trading day of grant, any other reasonable basis using actual transactions as reported by the securities market on which the stock is traded and consistently applied, or an average of prices over a specified period that occurs within the 30 days before and the 30 days after grant
- For non-publicly traded stock, a list of factors to be considered as to whether a valuation method is reasonable, and a presumption of reasonableness for certain valuation methods including an independent appraisal that meets the requirements for valuation of stock held by a tax-qualified employee stock ownership plan and was made no more than 12 months before the grant date

Dividends. The right to receive, upon exercise of a stock option or SAR, all or part of dividends declared and paid on the shares of stock subject to the option or SAR between the grant date and the exercise date will result in the stock option or SAR being treated as a deferred compensation arrangement subject to Section 409A (as an offset to the option exercise price or an increase in the amount payable under the SAR). If the right to dividends is set forth as a separate arrangement complying with Section 409A (e.g., payment made not on exercise but on a specified date or dates), the stock option or SAR would not be subject to Section 409A.

Replacement or Modification of Discount Stock Options and SARs. The proposed regulations extend until December 31, 2006 the deadline to replace discount stock options and SARs that were not fully vested as of December 31, 2004 (and are treated as providing for the deferral of compensation under Section 409A), with stock options or SARs that would not have been so treated on the original grant date. The replacement cannot result in the cancellation of a deferral in exchange for cash or vested stock (or other property) in 2006; such exchange can only take place in 2005.

The extension of the deadline for new payment elections can also be applied to modify a discount stock option or SAR to comply with Section 409A. The option or SAR may be amended to provide for one or more fixed exercise dates or to provide the holder of the option or SAR with an election to specify a fixed exercise date or dates.

Exercise of Discount Stock Option or SAR in 2005. The proposed regulations confirm that the exercise in 2005 of a stock option or SAR subject to Section 409A (e.g., because the exercise price was less than FMV on the grant date) is treated as a permissible cancellation of a deferral of compensation.

MISCELLANEOUS

Fiscal Year Employers. If the employer's fiscal year is other than the calendar year, elections to defer compensation (other than salary) that is based on the employer's fiscal year may be made prior to the beginning of the fiscal year. Otherwise, the deferral election must be made prior to the beginning of the calendar year in which the fiscal year commences.

Severance Compensation. The proposed regulations conclude that Congress intended that Section 409A should be applicable to arrangements providing for severance compensation (e.g., severance plans, change in control severance agreements and severance provisions in employment agreements), referred to in the regulations as "separation pay arrangements". The regulations provide an exemption from Section 409A for any separation pay arrangement under which

- The total payments do not exceed 2 times the employee's annual compensation for the calendar year prior to separation from service) or, if lower, 2 times the annual limit on compensation that may taken into account under tax-qualified retirement plans for such calendar year (the 2005 annual limit is \$210,000); and
- The arrangement requires that all payments be made by the end of the second calendar year following the calendar year in which the employee separates from service.

Certain reimbursement arrangements in connection with separation from service are treated as not subject to Section 409A, provided they only cover expenses that are incurred and reimbursed before the end of the second calendar year following the calendar year in which separation from service occurs. The covered reimbursement arrangements include medical expenses, moving expenses and outplacement expenses.

Separation pay arrangements that are treated as deferred compensation and provide payment due to involuntary separation from service or under a "window program" are treated as a separate type of plan under the proposed regulations for purposes of the aggregation rules for plans of the same type.

Short-Term Deferrals. The proposed regulations make permanent the "short-term deferral" exception to treatment as deferred compensation subject to Section 409A, but remove the requirement that the terms of the plan or arrangement specify that payment will be made by a date that is within 2-1/2 months from the end of the first taxable year of the employee (or, if later, the employer) in which the amount is no longer subject to a substantial risk of forfeiture. Instead, if the amount is actually or constructively received by that date, there is no deferral of compensation for purposes of Section 409A. In addition, a payment made after the 2-/12 month deadline because it was impracticable, either administratively or economically, to make the payment by the deadline due to unforeseeable circumstances will satisfy the exception if payment is made as soon as reasonably practicable.

Determination of Key Employees. Section 409A requires that payments to "key employees" of public companies (generally limited to no more than the 50 highest-paid officers) made upon

separation from service (other than death or disability) must be delayed for at least 6 months following separation. Under the proposed regulations the determination of an employer's key employees is made by applying the rules set forth in IRC Section 416 to the 12-month period ending on the "identification date" selected by the employer (e.g., the calendar year). An employee who is a key employee as of the identification date will be considered to be a key employee during the 12-month period that commences on the first day of the fourth month following the identification date.

Future Guidance. The proposed regulations do not address the calculation of the amount of deferrals, the amount of income to be included if Section 409A is violated, the timing of inclusion of income and related withholding obligations, or the funding of deferred compensation in offshore trusts or pursuant to a change in the employer's financial health. Those topics will be addressed in future guidance.

This letter is intended to alert compensation professionals about developments that may affect their companies, and should not be considered or relied upon as legal advice. Specific questions about the applicability of the Act to compensation arrangements should be discussed with appropriate counsel. General questions applicable to deferred compensation legislation may be directed to Richard Alpern in our New York offices at 212-986-6330 or by email at ralpern@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.