

Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

November 3, 2005

**YEAR END ACTION ON DEFERRED COMPENSATION**

**Actions Items by December 31, 2005 in Response to Latest  
IRS Guidance on Deferred Compensation Provisions of Section 409A**

The latest guidance on the deferred compensation provisions of Section 409A of the Internal Revenue Code was issued by the Treasury Department and the Internal Revenue Service on September 29th.<sup>1</sup>

The guidance extends the transition relief in Notice 2005-1 until December 31, 2006 in certain respects only. As a result, companies and participants need to make certain decisions and take certain steps by the end of the year 2005. This alert letter discusses the actions that must be taken by the end of 2005 to comply with the deferred compensation provisions of Section 409A for those aspects of the transition relief which have not been extended.

We anticipate that subsequent alert letters will discuss other aspects of the proposed regulations in more detail.

**INITIAL DEFERRAL ELECTIONS**

Elections to defer salary and annual bonus for services performed in 2006 generally must be made by December 31, 2005. However, elections may be made after that date for annual bonus:

- Based on the fiscal year of a non-calendar year employer that begins in 2006; in general, the deferral elections must be made prior to the beginning of the fiscal year
- Meeting the definition of bonus compensation in Notice 2005-1 or performance-based compensation in the proposed regulations. The deferral elections must be made no later than June 30, 2006, or for an employer with a fiscal year other than the calendar year, 6 months before the end of the fiscal year. In any event, the bonus must be earned over a service period of 12 months.

**NEW PAYMENT ELECTIONS**

December 31, 2005 is the last day to make a new payment election as to the time or form of payment of amounts subject to Section 409A that are payable in 2006 in order to take advantage

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<sup>1</sup> Refer to our letter dated 10/7/05 which is available on our website at [http://www.fwcook.com/alert\\_letters/10-7-05\\_Heads-Up\\_On\\_Deferred\\_Compensation\\_Guidance.pdf](http://www.fwcook.com/alert_letters/10-7-05_Heads-Up_On_Deferred_Compensation_Guidance.pdf)

of the exception to the requirement that the election (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 plan or arrangement must be amended by December 31, 2005, to provide for the new payment elections. For amounts payable in 2007 and later years, the payment election and amendment deadline is December 31, 2006.

#### **CANCELLATION OF DEFERRALS; TERMINATION OF PLAN PARTICIPATION**

The deadline for participants to terminate their participation in a deferred compensation plan or arrangement with respect to amounts subject to Section 409A, or to cancel deferral elections involving such amounts, is December 31, 2005. Plan amendments necessary to permit the termination or cancellation by a participant must be adopted by the employer by December 31, 2005.

If an employer wants to unilaterally terminate participation by employees or cancel deferral elections for amounts subject to Section 409A (provided it has that right under the deferred compensation plan or arrangement, or the right to adopt an amendment permitting it to do so), the employer must act by December 31, 2005, including the adoption of appropriate amendments.

#### **TERMINATION OF GRANDFATHERED PLAN OR ARRANGEMENT**

The last day to amend a “grandfathered” deferred compensation plan or arrangement (i.e., a plan or arrangement adopted prior to January 1, 2005) to provide for its termination, without the amendment being treated as a material modification resulting in the loss of grandfather status, is December 31, 2005. To qualify for this transition relief, the amendment must also result in the distribution of all amounts deferred under the plan or arrangement in the year the termination takes place. Termination by December 31, 2005 will not be subject to the general termination rules, including the requirement of not adopting a deferred compensation plan or arrangement of the same type within 5 years after termination.

#### **DISCOUNT STOCK OPTIONS AND SARs**

Discount stock options or SARs subject to Section 409A (i.e., to the extent not vested on December 31, 2004) may be replaced until December 31, 2006 with an option or SAR that eliminates the discount (i.e., by increasing the exercise or base price to fair market value of the employer’s stock on the grant date). The deadline was December 31, 2005 under Notice 2005-1.

The deadline remains December 31, 2005 if the employer wants to provide a payment of cash or fully vested stock (or other property) to compensate the holder of the option or SAR for the elimination of the discount. A promise to replace the discount with cash, restricted stock or other property that is subject to a vesting requirement may be made at any time in 2006.

In addition, if a discount stock option or SAR otherwise subject to Section 409A is exercised by December 31, 2005, it will be treated as a cancellation of a deferral.

**MARCH 15, 2005 INITIAL DEFERRAL ELECTIONS**

If an employer took advantage of the transition rule in Notice 2005-1 to permit initial deferral elections for salary and bonus earned in 2005 to be made by March 15, 2005, amendment of the deferred compensation plan or arrangement relating to the transition rule must be adopted by December 31, 2005.

**FORM 8-K DISCLOSURE**

An amendment of a deferred compensation plan or arrangement by a public company, as well as the replacement of discount stock options and SARs, will likely require the filing of Form 8-K with the Securities Exchange Commission within 4 business days after the adoption of the amendment or the replacement. The amendment would be required to be filed with the next Form 10-Q or 10-K if not filed with the Form 8-K.

**TRANSITION RELIEF DEADLINES**

Set forth below is the transition relief deadline following the issuance of the proposed regulations

<ul style="list-style-type: none"> <li>• Initial Deferral Elections for 2006 Services               <ul style="list-style-type: none"> <li>— Calendar year employer, not performance-based</li> <li>— Calendar year employer, performance-based</li> <li>— Fiscal year employer, not performance-based</li> <li>— Fiscal year employer, performance-based</li> </ul> </li> </ul>	12/31/05 6/30/06 Prior to beginning of fiscal year 6 months prior to end of fiscal year
<ul style="list-style-type: none"> <li>• New Payment Elections               <ul style="list-style-type: none"> <li>— Amounts payable in 2006</li> <li>— Amounts payable after 2006</li> </ul> </li> </ul>	12/31/05 12/31/06
<ul style="list-style-type: none"> <li>• Cancellation of deferrals and termination of plan participation</li> </ul>	12/31/05
<ul style="list-style-type: none"> <li>• Exercise of discount stock options and SARs (if not amended or replaced)</li> </ul>	12/31/05
<ul style="list-style-type: none"> <li>• Amendments to terminate grandfathered plans and arrangements</li> </ul>	12/31/05
<ul style="list-style-type: none"> <li>• Replacement of discount stock options and SARs               <ul style="list-style-type: none"> <li>— Payment of cash or vested stock (or property) included</li> <li>— No payment or payment subject to vesting</li> </ul> </li> </ul>	12/31/05 12/31/06

<ul style="list-style-type: none"> <li>• Amendments to comply with Section 409A <ul style="list-style-type: none"> <li>— 2005 new payment elections, cancellation of deferrals, termination of plan participation, and March 15 initial deferral elections</li> <li>— Other amendments to comply with Section 409A</li> </ul> </li> </ul>	12/31/05 12/31/06
<ul style="list-style-type: none"> <li>• Payments controlled by elections under tax-qualified retirement plans</li> </ul>	12/31/06

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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](mailto:ralpern@fwcook.com). Copies of this letter and other published materials are available on our website, [www.fwcook.com](http://www.fwcook.com) under the following links:

<u>Date</u>	<u>Title</u>	<u>Website Link</u>
October 12, 2004	Heads-Up On Deferred Compensation Legislation	<a href="http://www.fwcook.com/alert_letters/10-12-04%20Heads-Up%20on%20Deferred%20Compensation....pdf">http://www.fwcook.com/alert_letters/10-12-04%20Heads-Up%20on%20Deferred%20Compensation....pdf</a>
December 2, 2004	Provisions Affecting Deferred Compensation in the American Jobs Creation Act of 2004	<a href="http://www.fwcook.com/alert_letters/12-2-04_Provisions_Affecting_Deferred_Compensation.pdf">http://www.fwcook.com/alert_letters/12-2-04_Provisions_Affecting_Deferred_Compensation.pdf</a>
December 22, 2004	Heads-Up On Deferred Compensation Guidance	<a href="http://www.fwcook.com/alert_letters/12-22-04%20Heads-Up%20on%20Deferred%20Compensation%20Guidance.pdf">http://www.fwcook.com/alert_letters/12-22-04%20Heads-Up%20on%20Deferred%20Compensation%20Guidance.pdf</a>
February 28, 2005	Action Items in Response to IRS Guidance on Deferred Compensation	<a href="http://www.fwcook.com/alert_letters/2-28-05%20Action%20Items%20In%20Reponse%20to%20IRS%20Guidance%20On....pdf">http://www.fwcook.com/alert_letters/2-28-05%20Action%20Items%20In%20Reponse%20to%20IRS%20Guidance%20On....pdf</a>
October 7, 2005	Heads-Up On Deferred Compensation Guidance	<a href="http://www.fwcook.com/alert_letters/10-7-05_Heads-Up_On_Deferred_Compensation_Guidance.pdf">http://www.fwcook.com/alert_letters/10-7-05_Heads-Up_On_Deferred_Compensation_Guidance.pdf</a>