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HEADS-UP ON DEFERRED COMPENSATION GUIDANCE

**IRS Guidance on Provisions of American Jobs Creation Act of 2004 –
Stock-Settled SARs of Public Companies Permissible; Transition Rules Provided**

On December 20th the Internal Revenue Service (IRS) issued Notice 2005-1 providing guidance on the deferred compensation provisions of the American Jobs Creation Act of 2004. The Act added new Section 409A to the Internal Revenue Code, which makes compensation deferred under a nonqualified deferred compensation plan taxable on a current basis (or, if later, when vested), unless certain requirements are met.¹ The guidance confirms the broad coverage of arrangements considered to provide for the “deferral of compensation” which are treated as nonqualified deferred compensation plans in addition to traditional deferred compensation plans, including cash-settled stock appreciation rights, discount stock options, supplemental retirement plans and excess retirement plans (i.e., plans providing benefits or contributions in excess of the limits for tax-qualified retirement plans).

This alert letter highlights the major aspects of the IRS guidance, which is “... the first part of what is expected to be a series of guidance with respect to the application of §409A” according to Notice 2005-1. A subsequent alert letter will discuss the guidance in more detail.

EQUITY-BASED COMPENSATION

Stock Appreciation Rights (SARs). Stock-settled SARs of public companies with an exercise price of not less than the fair market value (FMV) of the company’s stock on the date of grant will not be treated as providing for the deferral of compensation.

Until further IRS guidance is issued, SARs of all companies which are paid in cash or stock, or are cancelled for consideration, will not be treated as the payment of deferred compensation subject to Section 409A if

- The SAR was granted pursuant to a program in effect prior to October 4, 2004; and
- The exercise price of the SAR is not less than the FMV of the company’s stock on the grant date.

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

Stock Options in Tandem with Cash SARs. Although a nonqualified stock option with an exercise price that is no less than the FMV of the stock on the grant date is generally not treated as providing for the deferral of compensation, if the option is part of a tandem arrangement with an SAR that permits cash settlement, the stock option will be treated as providing for the deferral of compensation and will be subject to Section 409A.

Restricted/Deferred Stock. Restricted stock (i.e., grant of actual shares of stock subject to time-based or performance-based vesting) does not involve the deferral of compensation in the absence of a deferral arrangement which is part of the grant. Deferred stock (i.e., the legally binding right to receive stock from the employer in the future, that does not involve a current grant of actual shares and typically is subject to time-based or performance-based vesting) may provide for the deferral of compensation and be subject to Section 409A.

Replacement of Discount Stock Options and SARs. Stock options and SARs which are not fully vested as of December 31, 2004 and will be treated as providing for the deferral of compensation under Section 409A (e.g., a discount stock option or an SAR with a cash settlement feature) can be replaced no later than December 31, 2005 with stock options or SARs which would not have been so treated on the original grant date. The replacement options or SARs can be adjusted to increase the number of shares subject to the options or SARs in accordance with the rules for substitution or assumption of statutory options in a merger or consolidation. SARs can also be converted into options.

TRANSITION RULES

Amounts Deferred Prior to 2005. A bonus for services in 2004 which is payable in 2005 will not be considered to be deferred before January 1, 2005 and will be subject to Section 409A if:

- The employer retains discretion to reduce the bonus amount (e.g. “negative discretion” applied under a formula); or
- The employee must perform further services after December 31, 2004 (beyond the end of the payroll period which includes that date) or the bonus is otherwise subject to a substantial risk of forfeiture (e.g., the bonus is forfeited if the employee’s employment terminates prior to the date the bonus is otherwise payable).

Bonus Compensation Treated as Performance-Based Compensation. Under Section 409A, elections to defer performance-based compensation based on a performance period of at least 12 months may be made no later than 6 months prior to the end of the performance period. Until additional guidance is issued, bonus compensation will be treated as performance-based compensation if:

- Payment of the compensation or the amount of the compensation is variable and contingent on the satisfaction of organizational or individual performance criteria; and

- The performance criteria are not substantially certain to be met at the time deferral elections may be made.

Compensation based solely on the value or appreciation in value of the company or its stock will not be treated as bonus compensation and a deferral election would have to be made before the performance period commences.

Short-Term Deferrals. Until additional guidance is issued, there is no deferral of compensation if the terms of a plan under which compensation is earned over a multi-year period (e.g., a bonus earned over a 3-year performance period) provide that payment is required to be made within a short time (i.e., 2-1/2 months) from the end of the first taxable year of the employee (or the employer) in which the amount is no longer subject to a substantial risk of forfeiture and the amount is actually or constructively received within that time. As a result, payment of the compensation could be accelerated and would not be subject to a 6-month delay in payment to a key employee of a public company following separation from service.

Deferral Elections by March 15, 2005. An election to defer compensation that relates in whole or in part to services performed on or before December 31, 2005 can be made by March 15, 2005 if the amount to which the election relates is not payable at the time of the election. According to public remarks by Treasury Department officials discussing the guidance, this election deadline also applies to bonuses earned in 2004 that are payable in 2005 and treated as subject to Section 409A.

The plan must be in existence prior to 2005 and be amended by December 31, 2005 to comply with requirements of Section 409A, the deferral election must be made in accordance with the terms of the plan as amended by that date, and the plan must otherwise operated in accordance with Section 409A's requirements.

Plan Amendments by December 31, 2005. A plan adopted before December 31, 2004 may be amended no later than December 31, 2005 to bring it in compliance with the requirements of Section 409A. The plan must be operated in good faith compliance with Section 409A and the provisions of Notice 2005-1 during 2005.

Plan Suspension or Termination. A plan will not be considered to be materially modified, which would otherwise subject it to the requirements of Section 409A, if it is amended to suspend future deferrals. Terminating a plan by December 31, 2005 will not be treated as a material modification as long as all amounts deferred under the plan are included in income in the year in which the plan is terminated.

New Payment Elections. If a plan is amended by December 31, 2005 to permit new payment elections with respect to amounts previously deferred and the elections are made by that date, the new elections will not be treated as a change in the form and timing of payment which would otherwise be subject to the requirements of Section 409A.

Termination of Participation/Cancellation of Deferral Election. A plan may be amended by December 31, 2005 to permit participants at any time during 2005 to terminate plan participation

or cancel a deferral election with respect to amounts subject to Section 409A. Any amounts affected by the termination or cancellation must be includible in the income of participants in the year in which the amounts are earned or, if later, when vested. In addition, the termination or cancellation may be made unilaterally by the employer without any election by participants.

MISCELLANEOUS

Payments Based on Qualified Retirement Plan Election. Payments under supplemental executive retirement plans and excess retirement plans which are controlled by payment elections made under a tax-qualified retirement plan can be made or commenced in 2005 without violating the requirements of Section 409A relating to the timing and form of payment.

Severance Plans. Plans providing for severance pay upon an involuntary termination of employment which do not cover any key employees are not subject to the requirements of Section 409A during calendar year 2005

Exceptions to Prohibition on Acceleration. A plan which does not have a de minimis cash-out payment provisions may be amended with respect to all amounts deferred under the plan to provide for the acceleration of the time or schedule of payments if:

- Payment is made in connection with termination of a participant's entire interest in the plan;
- The payment is not greater than \$10,000; and
- Payment is made by the later of
 - December 31 of the calendar year in which the participant separates from service
 - 2-1/2 months following the participant's separation of service

In addition, a plan may be amended with respect to future deferrals only to provide for a lump sum payment of a participant's interest in the plan if the value of the interest at the time it is payable is less than an amount specified by the plan.

A plan may also be amended to pay FICA taxes on compensation deferred under the plan, as well as the income tax on such payment.

Change in Control. The definition of change in control (CIC) in Notice 2005-1 is substantially similar to the CIC definition under the golden parachute rules of Section 280G of the Internal Revenue Code, except for increased percentages relating to a change in effective control and a change in the ownership of a substantial portion of assets. A payment will be treated as made upon a CIC if pursuant to a plan the company exercises discretion to terminate the plan and distribute the deferred compensation within 12 months after the CIC.

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.