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Action Items in Response to IRS Guidance on Deferred Compensation Elections, Amendments, Cancellations and Terminations in 2005

The initial Internal Revenue Service (IRS) guidance, Notice 2005-1, on the deferred compensation provisions of new Section 409A of the Internal Revenue Code (IRC) was issued on December 20, 2004 and revised on January 5, 2005.¹ The guidance provides transition rules for 2005 for nonqualified deferred compensation plans (i.e., plans and agreements providing for the “deferral of compensation”) that are subject to Section 409A with respect to deferral and payment elections, amendments, termination of participation, cancellation of deferrals, and plan termination.

This alert letter discusses the major action items for 2005 in response to Notice 2005-1, as well as the deadlines for taking action. Our December 22nd alert letter highlighted the major aspects of the guidance.²

IMMEDIATELY

A critical first step companies should take is to review outstanding plans and agreements to determine which of them are treated as deferred compensation plans subject to the new rules of Section 409A, as well as which ones are not. In addition to plans providing for deferrals of all or a portion of salary, bonus or directors’ fees, certain arrangements that one would not ordinarily consider to be deferred compensation plans are also treated as providing for the deferral of compensation, and are covered by Section 409A if they provide for deferrals in years beginning after December 31, 2004 or if they are materially modified after October 3, 2004; i.e.:

- Restricted stock units that provide for payment more than 2-1/2 months after the year in which they vest
- Stock appreciation rights (SARs) if:
 - The exercise price is (or may be under the terms of the SAR) less than the fair market value of the company’s stock on the grant date;
 - E.g., on the date an SAR is added to a stock option with the same exercise price as the option, the fair market value (FMV) of the company’s stock is higher than the exercise price; or

¹ Section 409A was added by the American Jobs Creation Act of 2004. 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 letter dated 12/22/04, which is available on our website at http://www.fwcook.com/alert_letters/12-22-04_Heads-Up_on_Deferred_Compensation_Guidance.pdf

- Payment may be made in cash (subject to an exception until further guidance is issued if the SAR is or was granted pursuant to a program in effect prior to October 4, 2004);
 - SARs issued by non-public companies (subject to the exception described above); or
 - The SARs are to be paid in stock and provide for the opportunity to defer payment after exercise
- Stock options in tandem with cash SARs or SARs issued by non-public companies (subject to the exception discussed above)
 - Stock options that provide the opportunity to defer payment after exercise (i.e., stock option gain deferral)
 - Discount stock options (i.e., options with an exercise price that is (or may be under the terms of the options) less than FMV of the company's stock on the grant date)
 - Stock options granted in connection with a merger to replace options of the acquired company granted at FMV will not be treated as discount stock options if the replacement complies with requirements for replacing incentive stock options in mergers
 - Deferred stock (i.e., the legally binding right to receive vested company stock in the future)
 - Phantom stock, whether settled in cash or stock
 - Employee stock purchase plans that do not meet the requirements of IRC Section 423
 - Supplemental retirement plans and excess retirement plans (i.e., plans providing benefits or contributions in excess of the limits for tax-qualified retirement plans)
 - Severance agreements and plans, subject to further IRS guidance
 - For 2005, agreements and plans providing severance pay on involuntary termination of employment that are collectively bargained or do not cover any key employees (as defined in IRC Section 416(i) for top heavy retirement plans) are not treated as deferred compensation plans

If a deferred compensation plan will have continuing deferrals in 2005 and subsequent years, another important step is to determine the amount of compensation that is not subject to Section 409A because the deferral occurred prior to January 1, 2005. The plan can provide that compensation deferred prior to 2005 will continue to be subject to the terms of the plan as in

effect on October 3, 2004, regardless of whether those terms meet the requirements of Section 409A. For compensation to be considered deferred prior to January 1, 2005:

- The employee or other service provider must have a legally binding right to be paid the compensation (i.e., there can be no employer discretion to reduce the amount of the compensation³); and
- The compensation must be earned and vested as of December 31, 2004.

The determination of the amount depends on whether the plan is treated as an equity-based compensation plan, an account balance plan (a plan under which participants are entitled to the balances credited to their accounts that are derived from periodic credits of principal and “earnings”) or a non-account balance plan (e.g., a defined benefit supplemented retirement plan).

MARCH 15, 2005

Elections to defer compensation relating to services performed in 2005 (in whole or in part) can be made by March 15, 2005, if the amount subject to the election is not payable at the time of the election, and the plan under which the deferral election is made was in existence on December 31, 2004. Accordingly, deferral elections can be made by March 15, 2005 with respect to:

- Salary that is not payable at the time of the election
- Bonus compensation earned in 2005 (in whole or in part) regardless of whether a deferral election is permitted by June 30, 2005 (see below).

The March 15, 2005 election deadline also applies to a bonus for 2004 services which is not considered to be deferred prior to January 1, 2005 (e.g., because the bonus is forfeited if employment terminates before the bonus payment date).

In order to take advantage of the March 15, 2005 election deadline, the plan must be amended by December 31, 2005 to comply with the 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 be operated in accordance with Section 409A’s requirements.

JUNE 30, 2005

Notice 2005-1 provides that “bonus compensation” will be treated as performance-based compensation until further guidance is issued⁴ and, accordingly, an election to defer the bonus compensation can be made no later than 6 months before the end of the service period over which the bonus compensation is earned (provided that the service period is at least 12 months).

³ For example, the “negative discretion” of the compensation committee to reduce the bonus payable under a formula in an annual or long-term bonus plan.

⁴ Notice 2005-1 stated that the additional guidance is anticipated to have requirements for performance-based compensation that “will be more restrictive” than the requirements for bonus compensation in the Notice.

As a result, an election to defer bonus compensation earned based on services performed during calendar year 2005 can be made by June 30, 2005.

Compensation is treated as bonus compensation for this purpose 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.

The performance criteria may be subjective if:

- The criteria relates to the performance of the employee, a group of employees or a business unit; and
- The determination of whether the criteria have been met must not be made by the employee or a family member of the employee.

There is no requirement that performance criteria be approved by the compensation committee of the board of directors or by stockholders. Any amount that will be paid regardless of performance or based on a level of performance that is substantially certain to be met when the criteria is established (e.g., \$100 in sales revenue) will not be treated as bonus compensation. In addition, compensation based solely on the value or appreciation in value of the company or its stock will not be treated as bonus compensation.

DECEMBER 31, 2005

Plan Amendments -- December 31, 2005 is the deadline for amending plans and agreements to conform their terms to the requirements of Section 409A. In addition, the plan or agreement must be operated during 2005 in good faith compliance with Section 409A and the provisions of Notice 2005-1. Among the provisions that must be reviewed for necessary amendments are:

- Timing of initial and subsequent deferral elections
- Permissible distribution events, including
 - Adding a 6-month delay for payments on separation from service of “key employees” of public companies
 - Revising, as applicable, the definitions of change in control,⁵ disability and hardship

⁵ The definition in Notice 2005-1 is very different than the definition in virtually every deferred compensation plan and agreement. Although it is permissible to determine change in control based on events relating to the employers corporation, the corporation liable for payment, or the ultimate parent corporation, many of the events constituting a change in control under the Notice are more restrictive than the typical definition found in deferred compensation plans and agreements.

— Elimination of distributions upon employee request, even with a 10% “haircut” (i.e., forfeiture of 10% of the participant’s deferred compensation account)

-- There is no provision for “haircut” distributions under Section 409A

- The ability of the participant, the employer or a plan committee to accelerate distributions, except under the limited circumstances permitted by Notice 2005-1 (and any subsequent IRS guidance)

Plan Termination -- If a plan or agreement is terminated by December 31, 2005 the termination will not be treated as material modification that would otherwise make it subject to Section 409A. In order to take advantage of this exception, all amounts deferred under the plan or agreement must be distributed and included in income in the year in which the plan or agreement is terminated (i.e., in 2005).

New Payment Elections -- Participants may make new payment elections at any time during 2005 with respect to deferred amounts subject to Section 409A, without the elections being treated as

- A change in the form or timing of payment that would require a delay in payment for five years from the originally scheduled payment date; or
- An impermissible acceleration of payment (e.g., electing a lump sum payment instead of payment in installments over a period of ten years)

The deferred compensation plan or agreement must be amended by December 31, 2005 to permit the new payment elections.

Termination of Participation/Cancellation of Deferral Election -- Participants may also at any time during 2005 elect to terminate participation in a deferred compensation plan or agreement or cancel a deferral election pursuant to the plan or agreement with respect to amounts subject to Section 409A. The plan or agreement must be amended by December 31, 2005 to permit participants to make such election. It is permissible to provide that the elections can only be made during a limited period during 2005. Any amounts affected by the termination or cancellation must be includible in the income of participants in 2005, or if later, in the year in which the amounts are earned and vested. In addition, the termination or cancellation may be made unilaterally by the employer without any election by participants.

Replacement/Modification of Discount Stock Options and SAR -- Discount stock options and SARs, SARs with a cash settlement feature and SARs issued by a non-public company that are not fully vested as of December 31, 2004 can be replaced during 2005 with an equity-based award that would not have been treated on the original grant date as providing for the deferral of compensation under Section 409A as follows:

<u>Existing Award</u>	<u>Replacement Award</u>
<ul style="list-style-type: none"> • Discount stock option 	<ul style="list-style-type: none"> • Stock option with exercise price equal to FMV on original grant-date (FMV Exercise Price)
<ul style="list-style-type: none"> • Discount stock-settled SAR 	<ul style="list-style-type: none"> • Stock-settled SAR with FMV Exercise Price
<ul style="list-style-type: none"> • Cash-settled SAR 	<ul style="list-style-type: none"> • Stock-settled SAR • Stock option
<ul style="list-style-type: none"> • SAR of non-public company 	<ul style="list-style-type: none"> • Stock option

The replacement options or SARs for awards with a discount exercise price 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.

In addition, discount stock options, cash settled SARs and SARs issued by non-public companies can be modified during 2005 to provide for a fixed exercise date (or dates) that would satisfy the requirements of Section 409A. The modification to the options and SARs may permit the participant to elect no later than December 31, 2005 the fixed exercise date or dates. The modification and election will not be treated as a change in the form or timing of payment or an impermissible acceleration of payment.

If the replacement or modification is not made by December 31, 2005, discount stock options and stock-settled SARs will be treated as nonqualified deferred compensation and subject to tax (and the 20% additional tax) as they vest. Cash-settled SARs and SARs of non-public companies will be treated similarly if they do not qualify for the exception described on page 2.

PROCEED WITH CAUTION

The IRS has indicated that additional guidance on Section 409A will be issued by the end of June. It is expected that the guidance will address significant aspects of Section 409A that were not covered by Notice 2005-1, and, hopefully, the issues that were created by, or remain unclear after, Notice 2005-1. In light of the December 31, 2005 deadline for various actions discussed above, employers and participants should proceed cautiously and consider refraining from final action until the additional guidance is issued.

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.