



## Deferred Compensation Update

### Guidance from the IRS on New IRC Section 409A

**T**he American Jobs Creation Act of 2004 added a new section to the Internal Revenue Code (Section 409A) regulating so-called “nonqualified deferred compensation plans.” When Section 409A was first enacted, it was widely believed that many common compensation arrangements not thought to involve nonqualified deferred compensation, including non-statutory stock options, stock appreciation rights, bonus programs and severance plans, would be adversely impacted. On December 20, 2004, the Internal Revenue Service released Notice 2005-1. Notice 2005-1 provides the Service’s initial guidance on the application of Section 409A, including welcome relief with regard to stock options, stock appreciation rights, bonus programs and transition issues. This Thoughtful Pay Alert summarizes (in the form of questions and answers) some of the more important issues covered by Notice 2005-1.

#### What does Section 409A provide?

Section 409A provides that compensation deferred under a “nonqualified deferred compensation plan” is includible in gross income in the year of deferral, unless (i) certain requirements are met, or (ii) the compensation is subject to a substantial risk of forfeiture (i.e., it is unvested).

#### What is a nonqualified deferred compensation plan?

Notice 2005-1 defines a “nonqualified deferred compensation plan” quite broadly as any arrangement or agreement that provides for the deferral of compensation (to which the service provider has a cur-

rent, legally binding right) to a later year. These arrangements are different than 401(k) plans, pension plans and other “qualified” plans.

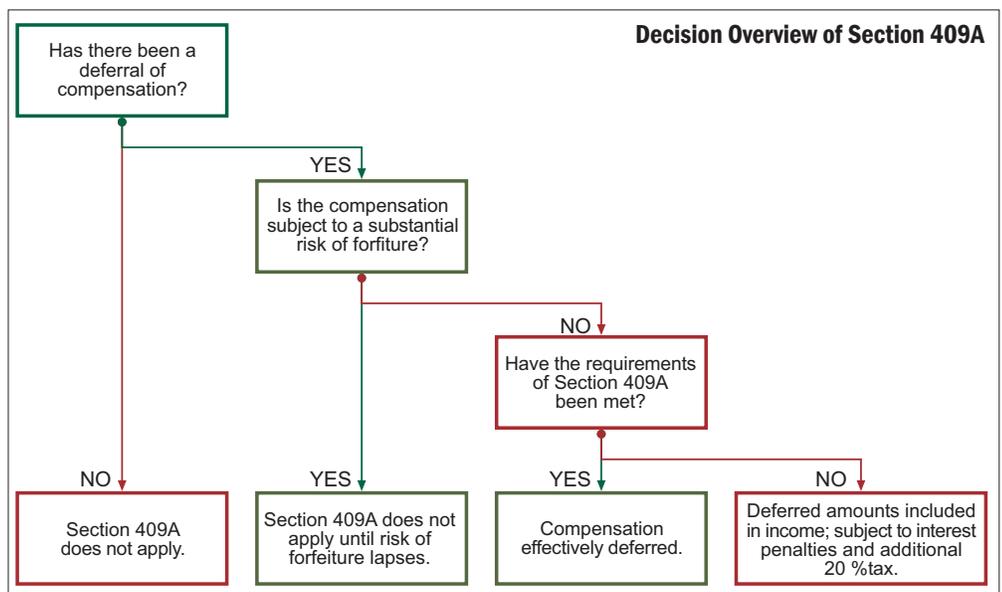
#### What are the federal tax consequences of a failure to comply with Section 409A?

Failure to comply with Section 409A results in current taxation of the deferred amount, interest, penalties and an additional 20% tax.

#### What does Section 409A require to avoid these consequences?

To avoid current taxation, interest and penalties, as described above, a nonqualified deferred compensation plan must meet the following requirements:

- An initial deferral must be made prior to the year in which the compensation is earned (or, for new plan participants, within 30 days of joining the plan).
- Only one subsequent election may be made to further defer the compensation, and such election may not be effective until 12 months after it is made and must defer the compensation for at least five years.





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- The plan must provide for payment of the deferred compensation only upon (i) separation from service (subject to a six month delay in the case of key employees), (ii) disability, (iii) death, (iv) the occurrence of an unforeseeable emergency, or (v) the time or schedule specified in the deferral election.
- The timing of the deferred payment or payment schedule generally may not be accelerated (but see additional discussion below).

### Is acceleration of the payment of deferred amounts permitted?

In general, Section 409A prohibits a nonqualified deferred compensation plan from permitting acceleration of the time or schedule of payments once a deferral election has been made, subject to several important exceptions:

- A plan may permit payments to be made within 12 months of a change of control.
- Acceleration of the time or schedule of payments is also permitted: (i) to fulfill a domestic relations order, (ii) to comply with a certificate of divestiture, (iii) to pay the FICA taxes on the deferred compensation, and (iv) with respect to certain *de minimis* amounts.

NOTE: Company stock plans and agreements, as well as individual agreements (e.g., employment and change of control agreements) should be reviewed to identify any acceleration or other provisions that might violate Section 409A.

### Does Section 409A contain any special rules applicable only to officers?

Section 409A provides that (i) distributions triggered by a termination of service of a “key employee” must be subject to a six month delay, and (ii) that severance plans covering “key employees” may involve a deferral of compensation. For these purposes, “key employees” are generally defined as a company’s fifty highest paid officers (or, if less, the top 10% of the company’s employees) whose compensation exceeds \$135,000. Certain stock ownership rules may also apply in determining whether someone is a “key employee.”

### How does Section 409A affect some common forms of compensation?

#### Incentive Stock Options and ESPPs

Stock options that meet the requirements of Section 422 (i.e., incentive stock options) or Section 423 (i.e., options granted under ESPPs) are not considered to involve the deferral of compensation. However, companies considering modifications to their ESPPs in light of the new stock

option expensing rules should proceed cautiously; many nonqualified ESPPs may be problematic under Section 409A to the extent that they result in the grant of discounted non-statutory stock options (see below).

#### Nonstatutory Stock Options

Nonstatutory stock options (i.e., compensatory stock options other than incentive stock options) will not be deemed to involve the deferral of compensation so long as they are granted at fair market value and are not granted in tandem with cash stock appreciation rights. Nonstatutory stock options granted below fair market value or in conjunction with cash stock appreciation rights must be structured with care or they may (a) be subject to Section 409A and (b) may fail to meet that Section’s requirements. Importantly, however, Notice 2005-1 provides that the substitution or assumption of nonstatutory stock options in a merger or similar corporate transaction will generally not be treated as the grant of discounted options and will not be subject to Section 409A.

*Example 1: Company A grants a nonstatutory stock option to Employee 1 covering stock with a fair market value per share of \$10 and with an exercise price per share of \$10. The option will not be subject to Section 409A.*

*Example 2: Assume the same facts as in Example 1, except that the exercise price per share is \$5. The option may be subject to Section 409A.*

*Example 3: Company A has granted a fair market value option to Employee 1. Subsequently, Company A’s stock price appreciates and Company A is acquired by Company B. Pursuant to the acquisition, Company B substitutes an option covering Company B stock for Employee 1’s original option for Company A stock. The terms of the substitution preserve the gain inherent in Employee 1’s original option immediately prior to the acquisition. The new option will not be subject to Section 409A.*

#### Stock Appreciation Rights

Stock-settled stock appreciation rights will not be subject to the requirements of Section 409A, so long as they are granted at fair market value and cover public company stock. Subject to certain transition relief noted below, cash-settled stock appreciation rights and stock appreciation rights covering private company stock may be deemed to involve a deferral of compensation and may be subject to the requirements of Section 409A.

*Example 1: Company A, a public company, grants a stock appreciation right to Employee 1 covering stock with a fair market value per share of \$10 and with an exercise price per share of \$10. The right may only be settled in*



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shares of Company A stock. The right will not be subject to Section 409A.

*Example 2:* Assume the same facts as in Example 1, except that Company A's stock is not publicly traded. The right may be subject to Section 409A.

*Example 3:* Assume the same facts as in Example 1, except that the right may be settled in cash. The right may be subject to Section 409A.

### Restricted Stock

Standard restricted stock programs will not be deemed to involve a deferral of compensation. However, restricted stock unit or deferred stock programs that permit deferral of share delivery beyond the date of vesting may be subject to Section 409A.

*Example 1:* Company A grants Employee 1 shares of company stock that vest and will be delivered to Employee 1 four years from the date of grant. This arrangement will not be subject to Section 409A.

*Example 2:* Assume the same facts as in Example 1, except that Employee 1 may elect to defer delivery of the shares to a later tax year. The right will be subject to Section 409A.

### Short-Term Deferrals

Compensation received within two-and-a-half months of the end of the year in which it is earned does not involve a deferral of compensation subject to Section 409A.

*Example:* Company A, a calendar year company, maintains an annual bonus plan. Bonus payments for amounts earned in a year are typically paid out in February of the following year. This arrangement will not be subject to Section 409A.

### Severance Plans

During 2005, severance plans that do not cover key employees are not subject to Section 409A. Severance programs that cover key employees must be carefully analyzed to determine whether Section 409A applies.

### Bonus Program Deferrals

A deferral election for bonus compensation relating to services performed over a period of at least 12 months will meet the requirements of Section 409A, so long as a deferral election is made at least six months before the end of the applicable service period.

*Example:* Company A, a calendar year company, maintains a long-term incentive plan with a three-year performance period. Performance is measured over the three-year performance period and bonuses are paid out following the end of the per-

formance period. Employee 1 is a participant in a performance period that commences January 1, 2005. Employee 1 must file a deferral election by June 30, 2007 to comply with Section 409A.

### When did Section 409A become effective?

Section 409A generally applies to amounts deferred after December 31, 2004. However, Section 409A also applies to amounts deferred on or before December 31, 2004 if the plan under which the deferral was made is or has been materially modified after October 3, 2004. For these purposes, a plan is considered materially modified if a benefit or right is enhanced or a new benefit or right is added to the plan.

### Does Notice 2005-1 provide any transition relief?

Notice 2005-1 provides transition relief in a number of areas:

- Nonqualified deferred compensation plans adopted before December 31, 2004 will be treated as complying with Section 409A if (i) they are operated in good faith compliance with the provisions of Section 409A and Notice 2005-1, and (ii) the plan document is amended on or before December 31, 2005 to comply with Section 409A.
- For nonqualified deferred compensation plans adopted before December 31, 2004, deferral elections for compensation relating to service to be rendered before December 31, 2005 will be effective so long as made on or before March 15, 2005.
- Amending a plan to stop future deferrals, or terminating a plan on or before December 31, 2005 and distributing all deferred amounts thereunder, will not be considered a material amendment and will not subject the plan or the compensation deferred thereunder to the requirements of Section 409A.
- Cancellation of stock options or stock appreciation rights that do not meet the requirements of 409A and replacement with options or rights that do meet its requirements will generally not be deemed a material modification (and will, therefore, avoid application of Section 409A), so long as the replacement is on a share for share basis, no additional benefit is conferred on the recipient and the replacement occurs before December 31, 2005.
- Settlement of stock appreciation rights (whether in stock or cash, and whether the right covers public or private company stock) will not be treated as involving a deferral of compensation, so long as the stock appreciation right was granted at fair market value pursuant to a program in effect before October 3, 2004.



# THOUGHTFUL PAY ALERT

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### What should companies do now?

Companies should act immediately to begin complying with Section 409A:

- All arrangements that could be considered non-qualified deferred compensation plans (e.g., traditional nonqualified deferred compensation plans, stock option and other equity programs, severance plans, etc.) should be reviewed to ensure operational compliance with Section 409A.
- Operational controls should be put in place to ensure that plans under which compensation was deferred prior to December 31, 2004 are not “materially modified,” inadvertently subjecting previously deferred compensation to Section 409A.
- Amendments bringing plans into compliance with Section 409A should be prepared for adoption before December 31, 2005.
- Careful consideration should be given to whether deferral elections should be made by March 15, 2005 for compensation relating to services to be rendered before December 31, 2005. ♦

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### About Compensia

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