

**Initial 409A Guidance Issued Providing Liberal Transition
Relief for Deferred Compensation Plans**

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On December 20, 2004, the Internal Revenue Service released its initial guidance concerning the recently enacted federal tax laws affecting nonqualified deferred compensation plans. Contained in the American Jobs Creation Act enacted earlier this year, Section 409A of the Internal Revenue Code imposes burdensome new requirements on deferred compensation and other executive compensation arrangements, including new requirements with respect to elections to defer base salary and bonuses, and elections with respect to distributions. The new law applies to deferral arrangements with employees and independent contractors, including board members.

Although the new law generally applies with respect to amounts deferred after December 31, 2004, it can be applicable to deferred amounts that were unvested as of December 31, 2004, regardless of when the deferral election was made, and in that respect has significant potential for retroactive application. The guidance released by the IRS in Notice 2005-1 (i) clarifies that nothing needed to be done by the end of 2004 to comply with the new law, (ii) explains how to implement the new requirements during 2005, and (iii) provides other guidance that will assist plan sponsors in complying. Additional guidance on the new law is expected to be released in 2005.

Background

New Code Section 409A generally provides that all amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture unless the plan meets certain new restrictions as to timing of deferral elections and distribution elections, permissible distribution events, acceleration of payments and subsequent deferral elections. Failure to comply with the requirements of Section 409A will result in a 20% additional tax on the payment recipient and interest at an enhanced rate in addition to taxation at the ordinary income rate. For a general overview of the legislation, click [here](#).

What Is Not Covered by Section 409A?

Section 409A does **not** apply to qualified employer plans (e.g., 401(k) or pension plans), tax-deferred annuities under Section 403(b), simplified employee pensions, SIMPLE IRAs, 457(b) arrangements or Section 501(c)(18) funded pension trusts. Section 409A also does **not** apply to bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans, Archer Medical Savings Accounts or Health Savings Accounts, or any other medical reimbursement arrangement. With respect to severance plans, Section 409A does **not** apply to collectively bargained severance plans, nor does it apply to plans that do not cover a "key employee" (generally, any employee with an annual compensation in excess of \$130,000, a 5% owner, or a 1% owner with compensation in excess of \$150,000), provided that the plan does not exceed certain limitations.

Grandfathered Plans and Arrangements

As a general matter, the new requirements do not apply to amounts deferred prior to January 1, 2005 so long as the arrangement is not materially modified after October 3, 2004. Earnings on grandfathered amounts are also grandfathered unless the arrangement is materially modified after October 3, 2004.

The Notice clarifies that an amount is deferred prior to January 1, 2005 if the service provider has a legally binding right to be paid the amount and the amount is earned and vested. An amount is earned and vested

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only if it is not subject to a substantial risk of forfeiture or conditioned by a requirement to provide further services. For example, an election to defer a bonus payable on March 15, 2005 as to the 2004 calendar year would not be grandfathered if the bonus were conditioned on the recipient's being employed by the company on March 15, 2005. In addition, the Notice suggests that discretion on the part of the employer to reduce the bonus amount will cause loss of grandfathering. However, a requirement that the service provider continue to provide services through the end of the payroll period that included December 31, 2004 but extends into 2005 will not necessarily cause loss of grandfathered status.

Material Modification

The Notice provides that a deferred compensation plan or arrangement is materially modified if a benefit or right existing as of October 3, 2004 is enhanced, or a new benefit or right is added. Such an addition or enhancement is a material modification even if brought about pursuant to an explicit discretion set forth in the plan prior to October 3, 2004. For example, even if the plan allows acceleration of vesting, discretionary accelerated vesting of rights under the plan on or after October 3, 2004 is a material modification causing the vested rights to become subject to the requirements of Section 409A. However, adding a new right or feature that is compliant with the requirements of Section 409A (e.g., a hardship distribution right) is not a material modification. The Notice also states that additional grants under a program (e.g., stock appreciation rights) may be a material modification of the program unless the new grants are "consistent with the service recipient's historical compensation practices." The interplay between the grandfather rules and the material modification rules is an area of ongoing concern, and a high level of care should be taken in making any changes to an arrangement thought to be grandfathered.

Transition Guidance-What Must Be Done by December 31, 2004?

Generally, nothing. The transition guidance provides a special "pass" from the otherwise applicable election deferral timing rules of the new law and permits deferral elections with respect to 2004 or 2005 to be made by March 15, 2005 (so long as the elections are made prior to the otherwise applicable payment date pursuant to a written plan document in place as of December 31, 2004). This transition relief applies to elections to defer amounts earned during 2004 or 2005 or amounts that relate to services performed during 2004 or 2005. Thus, neither plan sponsors nor participants need take any action to make deferral elections prior to January 1, 2005 for bonus or other compensation arrangements that reflect services performed in 2004 (or 2005) but that will not be fully earned, vested and payable until 2005.

What Must Employers Do During 2005?

This is another area in which the Notice provides a liberal transition period. By December 31, 2005, employers will need to have amended their deferred compensation plan documents to reflect the requirements of the new law. During 2005, pending issuance of further, more specific guidance, employers are required to operate their deferred compensation plans in reasonable, good-faith compliance with the law, including taking into account the new rule that allows later elections for performance-based compensation plans, so long as the elections are made at least six months prior to the end of the year. As a result, if an employer has calendar year performance-based bonus plans, for those bonuses payable in 2006 attributable to the 2005 year, that employer must obtain deferral elections by the end of June 2005. The IRS is likely to issue more specific guidance concerning performance-based compensation. However, we would expect that requiring deferral elections six months before the end of the performance period (as required by Code Section 409A) will constitute good-faith compliance with the new law.

Employees Can “Opt Out” of Their 2005 Deferral Elections

The transition guidance also provides that before the end of 2005, an employee can elect to cancel his or her 2005 deferral elections (made before March 15, 2005) and receive any amounts deferred during 2005, provided that the applicable plan document is amended before December 31, 2005 to permit the cancellation and provided that any amounts previously deferred during 2005 are includible in the employee's 2005 income. Thus, the “opt-out” avoids the 20% penalty. This special transition rule will permit employees to learn about the requirements of the new law (and about the plan sponsor's implementation decisions) during 2005 and decide whether or not they want their 2005 deferrals to be subjected to the new requirements.

Employers Can Terminate and Pay Out Existing Plans By December 31, 2005

Because the new law generally prohibits the acceleration of payments, for deferrals after 2004, employers will no longer have the ability to terminate their deferred compensation plans and distribute all benefits. Further, the new guidance provides that if an otherwise grandfathered plan is terminated, the termination will constitute a material modification and the otherwise grandfathered amounts will be subject to the new law (meaning that any distribution upon termination will constitute an accelerated payment and trigger the 20% penalty tax). Practically speaking, this would mean that employers cannot terminate and distribute their deferred compensation plans' account balances without triggering the 20% penalty. To provide a measure of transition relief, the new guidance provides that employers can terminate their deferred compensation plans (including grandfathered plans) and distribute any benefits by December 31, 2005. After that date, the termination and early payment of a deferred compensation plan could result in the employee incurring excise tax liability.

Effect on Various Kinds of Nonqualified Plans

The Notice impacts *nonqualified* defined benefit and defined contribution plans that permit the deferral of compensation. As a general matter, the Notice provides that the acceleration of distributions from either a nonqualified defined benefit plan or a nonqualified defined contribution plan is only permitted under the following circumstances: (i) a qualified domestic relations order, (ii) a conflict of interest divestiture, (iii) a change in control (as defined in the Notice), and (iv) the payment of employment taxes.

The Notice permits an election as to the timing and form of a payment under a nonqualified deferred compensation plan to be controlled by a payment election made by an employee under a *qualified* plan without violating Section 409A for periods ending on or before December 31, 2005, provided that the determination of the timing and the form of payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that cover payments.

Nonqualified Defined Contribution Plans: Nonqualified defined contribution plans (e.g., compensation plans and bonus arrangements) that allow benefit deferrals must be amended to comply with 409A by December 31, 2005.

The Notice provides for an exception to the general rules of Section 409A regarding the timing of deferral elections for the 2005 calendar year. Specifically, deferral elections under a nonqualified defined contribution plan made by March 15, 2005 will satisfy Section 409A.

Nonqualified Defined Benefit Plans: Nonqualified defined benefit plans (e.g., supplemental executive retirement plans) that allow benefit deferrals must be amended to comply with Section 409A by December 31, 2005. The grandfathered amount of the deferred benefit from a nonqualified defined benefit plan will be the present value of the earned and vested amount as of December 31, 2004 without the inclusion of early retirement subsidies for which the participant is not yet eligible. In effect, the grandfathered amount will be the amount of the benefit deferred as if the employee had been terminated on December 31, 2004.

457(f) Plans: The rules of Section 409A also apply to Code Section 457(f) plans. Nonelective deferred compensation of nonemployees and grandfathered plans under prior Code Section 457 transition rules are generally subject to Section 409A as well.

According to the Notice, the acceleration of distributions from a 457(f) plan will be allowed to pay withholding taxes due on the vesting of benefits. In addition, it should be noted that the definitions of a “rolling risk of forfeiture,” for Section 457(f) purposes, and a “substantial risk of forfeiture,” for Section 409A purposes, are different.

Equity Compensation

The Notice also addresses the treatment of equity compensation under the new law.

Stock Options: Options granted at a discount to fair market value exercise price are covered by the new rules. Incentive stock options and purchase rights granted under Section 423 employee stock purchase plans are not covered. Nonstatutory options that can never have an exercise price less than the fair market value per option share on the grant date, and that have no deferral features other than the deferral of taxation until exercise will also be exempt from the new law. In-the-money options assumed in a merger or other acquisition will not be subject to the new law, if the assumption is effected in compliance with the requirements of Treasury Regulation Section 1.421-1(a)(5)(iii), which in general precludes any increase in the aggregate option spread (the excess of the fair market value of the option shares over the exercise price payable for those shares) that exists immediately prior to the acquisition.

Stock Appreciation Rights: Stock appreciation rights (SARs) are covered under the new law, except for those that meet the following requirements: (i) the strike price can never be less than the fair market value of the underlying shares on the grant date, (ii) the underlying shares are traded on an established securities exchange, (iii) the right can only be settled in such traded shares, and (iv) there are no other deferral features. The guidance provides a generous relief provision for pre-October 4, 2004 SARs (or post-October 3, 2004 SARs issued under a then-existing plan, so long as not outside the ordinary course) that do not meet requirements (ii) and (iii) above. This provision will permit the cashing out of grandfathered SARs or substitution of nondiscounted SARs on options without triggering the 20% tax.

Restricted Stock: Unvested shares issued to a service provider will not be covered under the new law, whether or not a Section 83(b) election is made with respect to those shares.

Restricted Stock Units: If the shares subject to the units are issued immediately upon vesting, then the units will not be covered. If distribution is deferred beyond vesting, then the units will be covered but can easily comply with the new law if they incorporate a fixed distribution date (e.g., December 15 of each year) or otherwise pay out upon a permissible event (e.g., separation from service, change in control).

Phantom Stock: Phantom stock is covered, but again compliance with the new law is possible through the use of defined distribution dates that comply with one or more of the permissible distribution dates under the new law.

Although discounted options and private-company stock appreciation rights may be covered under the new law, compliance would still be possible even if the holders were free to exercise those options or rights whenever they chose, provided the distribution of the acquired shares or other return is tied to a permissible Section 409A distribution event.

Change in Control

The Notice also defines what constitutes a change in control for purposes of the permissible distribution events. There are three defined change in control events:

- change in ownership of more than 50% of the total fair market value or total voting power of the

outstanding stock,

- acquisition of securities possessing more than 35% of the total voting power of the outstanding stock over a 12-month period or certain changes in the majority of the board of directors over a 12-month period, or
- change in ownership of assets with a value in excess of 40% of the total gross fair market value of the corporation's assets.

As a general matter, change in control definitions in equity compensation or deferred compensation plans may tend not to be fully consistent with this definition and therefore will require review.

Severance Plans

Unfortunately, the Notice does not offer much assistance on the treatment of severance plans under the new law other than to exclude through the end of 2005 both collectively bargained severance plans and plans in which no key employees participate, provided such plans meet certain requirements as to amount (not in excess of two times annual compensation) and payout period (generally not in excess of 24 months) or pay benefits only upon an involuntary termination. For further information, please click [here](#).

Reporting Requirements

The Notice also discusses the new reporting requirements, which, as a general matter, require reporting in a separate box of Form W-2 all amounts of otherwise tax-deferred compensation.

Conclusion

Notice 2005-1 provides plan sponsors with a significant amount of flexibility in terms of (i) allowing deferral elections through March 15, 2005, (ii) permitting conforming amendments to plans through December 31, 2005, and (iii) permitting participant "opt-out" elections through December 31, 2005. The Notice also illustrates the government's thinking on several key issues and offers significant planning opportunities with respect to nongrandfathered stock appreciation rights and discounted stock options. The 2005 year provides plan sponsors a significant opportunity to review all existing deferred compensation arrangements, make conforming changes and determine how these programs will best operate under the new tax law.

For further information, please contact any of the following:

| Contact | Phone | Email |
|----------------------|--------------|--|
| David Ackerman | 312.324.1170 | dackerman@morganlewis.com |
| Robert L. Abramowitz | 215.963.4811 | rabramowitz@morganlewis.com |
| Mark H. Boxer | 415.442.1695 | mboxer@morganlewis.com |
| Althea R. Day | 202.739.5366 | aday@morganlewis.com |
| S. James DiBernardo | 650.843.7560 | jdibernardo@morganlewis.com |
| Brian J. Dougherty | 215.963.4833 | bdougherty@morganlewis.com |

| | | |
|------------------------|--------------|--|
| I. Lee Falk | 215.963.5616 | ilfalk@morganlewis.com |
| John G. Ferreira | 412.560.3350 | jferreira@morganlewis.com |
| Brian Hector | 312.324.1160 | bhector@morganlewis.com |
| Riva Johnson | 214.438.1557 | riva.johnson@morganlewis.com |
| John Kober | 214.438.1552 | jkober@morganlewis.com |
| Robert J. Lichtenstein | 215.963.5726 | rlichtenstein@morganlewis.com |
| Vivian S. McCardell | 215.963.5810 | vmccardell@morganlewis.com |
| Eva P. McComas | 415.442.1249 | emccomas@morganlewis.com |
| Gregory L. Needles | 202.739.5448 | gneedles@morganlewis.com |
| Zaitun Poonja | 650.843.7540 | zpoonja@morganlewis.com |
| Gary G. Quintiere | 202.739.5290 | gquintiere@morganlewis.com |
| Joseph E. Ronan, Jr. | 215.963.5793 | jronan@morganlewis.com |
| Gary S. Rothstein | 212.309.6360 | grothstein@morganlewis.com |
| Frank H. Smith, Jr. | 213.612.1016 | fsmith@morganlewis.com |
| Steven D. Spencer | 215.963.5714 | sspencer@morganlewis.com |
| R. Randall Tracht | 412.560.3352 | rtracht@morganlewis.com |
| Erin Turley | 214.438.1558 | eturley@morganlewis.com |
| Mims Maynard Zabriskie | 215.963.5036 | mzabriskie@morganlewis.com |