



Treasury Issues Guidance Implementing New Deferred Compensation Rules

January 5, 2005

As previously reported, the American Jobs Creation Act of 2004 was enacted in October 2004. It revised U.S. tax law dramatically with respect to the structure and operation of deferred compensation plans, including the imposition of a 20% additional tax on deferred amounts that do not meet the new requirements imposed by the Act. In December, Treasury issued its first round of guidance (Notice 2005-1) in which it clarified that:

- Deferral elections for 2004 and 2005 may be made as late as March 15, 2005 (if certain conditions are met); and
- Deferred compensation plans may be amended as late as December 31, 2005 to reflect the new law, so long as the plan is operated based on a good faith, reasonable interpretation of the statute and its purpose.

The Employee Benefits Practice Group of Morgan Lewis has issued the following analyses of the many issues raised by the new Act and the recent guidance:

- [Summary of statute](#)
- [Initial 409A Guidance Issued Providing Liberal Transition Relief for Deferred Compensation Plans](#)
- [Impact of New Deferred Compensation Tax Rules on Severance Pay Arrangements](#)

Morgan Lewis has also held two sets of webcasts on these new rules and intends to hold another set during January 2005 to discuss 2005 planning and compliance issues. We will also provide further updates as additional Treasury guidance is released.

If you would like further information regarding the issues raised in this Morgan Lewis LawFlash, please contact any of the following Morgan Lewis attorneys:

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

January 2005

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Initial 409A Guidance Issued Providing Liberal Transition

Relief for Deferred Compensation Plans

January 2005

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.

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New Federal Legislation Will Require Review of Deferred Compensation Plans

October 15, 2004

The nonqualified deferred compensation legislation that has been under consideration in Congress sporadically for several years is now a reality, pending the President's expected signature. Generally effective as of January 1, 2005, the new legislation will result in sweeping changes to the taxation of nonqualified deferred compensation. Key elements of the new legislation, which will be found in a new Internal Revenue Code (Code) section 409A, are as follows:

- **Definition of Nonqualified Deferred Compensation** The legislation's broad definition of nonqualified deferred compensation includes any plan, agreement or arrangement that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. Qualified plans that are exempted from the definition include qualified retirement plans, 403(b) plans, eligible 457(b) plans (but not ineligible plans under section 457(f)), 415 (excess) plans, SEPs and SIMPLEs. The legislation is not limited to elective arrangements (e.g., it applies to defined benefit SERPs), nor is it limited to arrangements between employers and employees. It can also reach an agreement that covers just one person. In addition, the new law appears to apply to stock options and equity arrangements issued at a discount to fair market value on the date of grant, stock appreciation rights, phantom stock, restricted or deferred stock units and, under some circumstances, even to severance pay plans.
- **Timing of Elections**
 - ◆ **Initial Elections** Unless Treasury regulations take a more flexible approach, initial elections to defer compensation must be made prior to the taxable year in which the services are performed and must specify the time and form of distribution. This change represents a dramatic departure from current practice under almost all existing deferred compensation plans. A plan may itself specify the mandatory time and form of payments or allow the participant to elect the time and form of payment, subject to the limitations on forms of distributions discussed below. There are two exceptions to the initial election provision: (i) the legislation allows a 30-day grace period for elections made by newly eligible participants in a deferred compensation plan; and (ii) deferral elections with respect to "performance-based compensation" where the performance period is 12 months or more can be made up to six months prior to the end of the

performance period. Generally, “performance-based compensation” refers to an amount that is “variable and contingent on the satisfaction of pre-established organizational or individual performance criteria,” and “not readily ascertainable” at the time of the election, which seems to be comparable to (though perhaps less strict than) the standards under section 162(m) of the Code.

- ◆ **Subsequent elections.** A subsequent election to delay the timing or form of distributions is allowed only if (i) the subsequent election is not effective for at least 12 months, (ii) except with respect to distributions because of death, disability or an unforeseen emergency, the subsequent election defers distributions for not less than five years from the date the first payment would otherwise be made, and (iii) a subsequent election relating to a specified time may not be made less than 12 months before the date of the first originally scheduled payment.
- **Distributions** The new legislation requires that compensation deferred under a plan may be distributed only upon six specified events. These are:
 - ◆ a separation from service,
 - ◆ the death of the participant,
 - ◆ the disability of the participant,
 - ◆ a specified time (or fixed schedule) specified under the plan or elected by the participant at the date of the deferral (this must be a date and cannot be a specified event),
 - ◆ a change in ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation, and
 - ◆ the occurrence of an unforeseen emergency (generally a severe financial hardship as defined in Code section 457).

Key employees (as determined under Code section 416) of a publicly traded corporation may not receive a distribution for at least six months following a separation from service.

The legislation specifically prohibits distributions based on a haircut provision or a trigger caused by the company’s failing financial health.

- **Acceleration of Payments** A plan may no longer permit the acceleration of the time or schedule of any payment under a plan except as permitted by IRS regulations, subject to the following exceptions:
 - ◆ distributions because of circumstances beyond the participant’s control (e.g., in order to comply with federal conflict of interest or court orders pursuant to a divorce),
 - ◆ withholding of employment taxes,
 - ◆ distributions necessary to pay income taxes due to vesting of a section 457(f) plan,

and

- ◆ distributions of minimal amounts for “administrative convenience.”
- **Effective Date** The legislation will be effective for deferrals made after December 31, 2004. Deferrals made prior to that date will generally be grandfathered, provided no material modifications have been made to the plan after October 3, 2004. For this purpose, existing deferrals are only grandfathered if the compensation was both earned and vested prior to the December 31, 2004 date; any attempt to vest currently unvested grants will likely be deemed a modification (see below).
- **Material Modification** A material modification is one that adds any benefit, right, or feature. For example, adding a haircut provision or accelerating vesting after October 3, 2004 would be a material modification. Note, however, that removing a provision permitting a distribution would not be a material modification.
- **Effect of a Violation** If a plan fails to meet all of the requirements of the new section 409A or is not operated in accordance with these requirements, all deferred amounts will be includable in the participant’s current gross income to the extent the compensation is no longer subject to a substantial risk of forfeiture. In addition, the participant will be subject to interest at the IRS underpayment rate plus one percentage point on all amounts that would have been included in income. An additional 20% tax will also be imposed the amounts required to be included in income. This set of “penalties” applies on a participant by participant basis; non-compliance as to one participant does not necessarily result in imposition of the “penalty” on another participant, nor does it disqualify the plan as a whole.
- **Treasury Guidance.** Treasury is obligated under the legislation to issue guidance within 60 days of the date of enactment that will:
 - ◆ permit a participant who elects a deferral subject to the new rules to cancel the deferral and be currently taxed, and
 - ◆ permit the terms of certain kinds of non-conforming elections made in 2004 to be modified to conform to the new rules.

In addition, Treasury will need to issue a broad array of interpretive guidance as to the new legislation, because Congress deferred to Treasury in large part with respect to specific articulation of the concepts set forth in the statute.

FAQs

Q: This seems like quite a lot of new requirements-what should I do now?

A: As a general rule, we would suggest that you continue with business as usual, pending issuance of guidance from Treasury and the IRS. The bill is effective immediately and there is no action available that will cause additional grandfathering. In fact, precipitous action, such as a plan amendment, may result in a material modification and loss of grandfathered status.

- Q:** Are all deferrals elected prior to January 1, 2005 grandfathered?
- A:** No, only those deferrals that are “earned and vested” are grandfathered. Accelerating vesting of deferrals after October 3 will be deemed a modification.
- Q:** If the deferral is grandfathered, does that mean it can continue to be subject to non-conforming election and distribution provisions (i.e., the “old” plan provisions)? Does the grandfather apply to earnings?
- A:** Yes, so long as the deferral is not materially modified.
- Q:** Does the new legislation override state contract law?
- A:** No, so there could be issues raised by a unilateral change to plan provisions if the plan does not permit such a change.
- Q:** Should we freeze our existing plans and establish new plans?
- A:** In many cases, there may not be a compelling reason to implement this strategy. However, there may be limited circumstances in which this approach will be advantageous. It certainly seems clear that the “new” plan would not be eligible for the 30-day deferral election.
- Q:** Does the enactment of this legislation mean that IRS will not audit pre-effective date years for deferred compensation practices that are now precluded?
- A:** No, the legislation expressly contemplates ongoing audit review of the pre-effective date practices.

What Should Be Done Now?

The legislation will necessarily involve significant changes to most existing deferred compensation plans, but we would suggest waiting until Treasury issues guidance to make changes. Plan sponsors should begin the process of determining which of their plans contain non-conforming provisions, and should alert plan participants making elections as to 2005 deferrals that the new rules will apply. We would recommend that you discuss your plan and your current circumstances with your Morgan Lewis lawyer to ascertain whether any action should be taken now.

Morgan Lewis’ Employee Benefits/Executive Compensation team has significant experience working with executive compensation issues. If you have questions or concerns, please contact the Morgan Lewis lawyer with whom you regularly work or any of the following:

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Impact of New Deferred Compensation Tax Rules on Severance Pay Arrangements

December 30, 2004

The American Jobs Creation Act of 2004, enacted in late October, added new Section 409A to the Internal Revenue Code, which significantly changes the taxation of nonqualified deferred compensation plans. Section 409A imposes restrictions on deferral elections, distribution elections, distribution events and acceleration of payments. Failure to comply with Section 409A will lead to immediate taxation of deferrals, with interest and a 20% penalty. Section 409A is generally applicable to amounts deferred after December 31, 2004, and thus in the context of severance payments would appear to apply to severance amounts payable on or after January 1, 2005 (at least where the severance event did not occur prior to January 1, 2005). For additional details on the overall effect of new Section 409A, see [New Federal Legislation Will Require Review of Deferred Compensation Plans](#).

“Nonqualified deferred compensation plan” is broadly defined to include any plan, agreement or arrangement (including one that covers only one person) that provides for the deferral of compensation, other than a qualified employer plan or a bona fide vacation, sick leave, compensatory time, disability pay or death benefit plan. Section 409A does not contain any specific exception for severance pay arrangements.

The Internal Revenue Service has issued Notice 2005-1, which provides transition guidance under Section 409A and, as to severance pay arrangements, excludes, through the end of 2005, only collectively-bargained severance plans and severance 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 twenty-four months). The guidance does not otherwise address severance plans, and thus a possible inference is that other forms of severance are subject to these new tax rules. It is not clear whether the exclusions set forth in the transitional guidance will be extended permanently or whether other forms of severance pay arrangements will be excluded when additional guidance is issued.

To the extent that severance pay is treated by the IRS as providing nonqualified deferred compensation and therefore subject to Section 409A, several restrictions may become applicable. For example, the timing of severance payments may have to be selected when the arrangement is initially established and it may not be possible to change such timing, accelerate the payment (even in exchange for consideration) or provide discretion to either the employer or the service provider to choose between a lump sum and installment payments. In addition, severance arrangements for “key employees” at public companies may be subject to the distribution limitations of Section 409A, which require that

distributions to such an executive on account of separation from service may not be made earlier than six months after the date of separation. Finally, payment of severance in connection with a change in control may be subject to restrictions.

It is expected that additional guidance on the application of Section 409A will be issued in the next few months. In the meantime, if you would like further information on the impact of Section 409A, please contact any of the following Morgan Lewis attorneys:

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