



Employee Benefits Law Information Memo

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GUIDANCE ISSUED ON RECENT DEFERRED COMPENSATION LEGISLATION

In Notice 2005-1, the Internal Revenue Service provides its initial guidance interpreting new Internal Revenue Code Section 409A ("409A") and its application to non-qualified deferred compensation ("NQDC") plans. The guidance describes how elections can be made or cancelled without violating 409A, and how plans can and must be amended to conform with the new rules. Notice 2005-1 also contains definitions for "plan," "change in control," and "substantial risk of forfeiture," as well as a description of the withholding and reporting requirements applicable to NQDC.

2005 Election Deadlines

Notice 2005-1 provides that, for plans in existence on or before December 31, 2004, the 409A timing of elections (i.e., by the close of the preceding taxable year or, for performance-based compensation, not later than six months before the end of the service period) will not be applicable to elections made on or before March 15, 2005, assuming that the amounts subject to the election have not been paid or become payable at the time of the election. The election must be made in accordance with the terms of the plan, as amended to comply with 409A.

New elections as to the form of payment of NQDC subject to 409A can be made with respect to amounts deferred prior to the election if the plan is so amended and the election is made by December 31, 2005. In addition, payments of grandfathered NQDC that are controlled by a payment election under a qualified plan will not violate 409A, if such NQDC payments are made or commence by December 31, 2005.

Cancellation of Plan Participation and Elections Permitted in 2005

In 2005, a plan may permit a participant to terminate participation or cancel a deferral election for amounts otherwise subject to 409A. The terms of the plan must be amended by December 31, 2005 to permit the termination or cancellation, and the amounts subject to the termination or cancellation must be included in income in the taxable year in which the amounts are earned and vested. Similarly, a plan may be amended to permit a payment to a participant during 2005 (or, if later, in the calendar year in which the amount is earned and vested) upon termination of participation in the plan or cancellation of the deferral election.

Good Faith Compliance; Amendments Required

A NQDC plan adopted before December 31, 2005 will not be treated as violating the distribution restrictions or election requirements of 409A, if the plan is operated in compliance with the provisions of 409A and Notice 2005-1 during 2005, and the plan is amended to conform with 409A (with respect to amounts subject to 409A) by December 31, 2005.

What Amounts are Grandfathered?

409A applies to NQDC deferred after December 31, 2004. Under Notice 2005-1, an amount is treated as deferred on or before December 31, 2004 only if the service provider's right to the compensation is earned and vested by December 31, 2004, and the service recipient has a binding, legal obligation

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to pay the compensation in a future taxable year. Amounts properly deferred on or before December 31, 2004 are “grandfathered” and, therefore, can be paid pursuant to the terms of the existing NQDC plan (even if non-compliant with 409A), provided that the grandfathered amounts are identifiable and the plan is not materially modified after October 3, 2004. Amending a plan to comply with 409A for amounts deferred after December 31, 2004 is not considered a material modification of the plan.

What Amounts Are Subject to 409A?

A plan provides for the deferral of compensation subject to 409A only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right to compensation that has not been actually or constructively received and included in gross income and that is payable in a later year. There is no legally binding right if the compensation may be unilaterally reduced by the service recipient after services have been performed, other than by offset for benefits provided under a qualified plan, investment losses or, in a final average pay plan, subsequent decreases in compensation.

Notice 2005-1 describes certain arrangements exempt from 409A:

- Normal payroll arrangements where compensation is paid after the close of the taxable year;
- An amount paid within 2½ months from the end of the first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (for example, bonuses paid after the end of the year);
- For 2005 only, severance arrangements that are either collectively bargained or cover no key employees;
- Length of service award programs for bona fide volunteers;
- Incentive stock options and employee stock purchase plans;
- Non-statutory stock options, if the exercise price is not less than the fair market value on the date of grant (using any reasonable valuation method), no additional deferral of income following exercise is available, and the option is otherwise taxable under Section 83 of the Internal Revenue Code;
- Partnership interests, including the issuance of a profit interest or a capital interest, are to be treated in the same manner as the issuance of stock, until further guidance is issued;
- Stock appreciation rights (SAR), if the underlying stock is traded on an established securities market, the exercise price is not less than the fair market value of the underlying stock on the date of grant, the SAR is settled in stock (not cash), and no additional deferral of income following exercise is available. Pending further

guidance, if the program was in place on or before October 3, 2004, a SAR exercise settled in stock or cash, or the cancellation of a SAR for consideration, will not be subject to 409A.

Certain Acceleration of Payments Permitted

In general, a plan subject to 409A may not permit the acceleration of the time or schedule of payments. However, the guidance provides that acceleration is permitted:

- Pursuant to a domestic relations order;
- To comply with a certificate of divestiture;
- To pay income taxes due on a plan subject to Internal Revenue Code Section 457(f);
- To make a lump sum payment of \$10,000 or less that represents a participant’s entire plan interest within a short period following separation from service; and
- To pay FICA taxes.

More Guidance Anticipated

Further guidance is expected. In the meantime, plan sponsors should determine whether it is practical and desirable to “grandfather” NQDC amounts. Here, the ability to segregate and identify amounts that are not subject to 409A will be critical. With respect to deferrals subject to 409A, plan sponsors must prepare to solicit deferral elections by March 15, 2005, knowing that limited additional elections may be authorized before the end of 2005.

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