

TAX MANAGEMENT COMPENSATION PLANNING JOURNAL

Reproduced with permission from Tax Management Compensation Planning Journal, Vol. 33, No. 3, 03/04/2005. Copyright © 2005 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Treasury and IRS Issue Key Guidance on New Nonqualified Deferred Compensation Law

by Marjorie M. Glover, Esq.,*
Sarah C. Richards, Esq.,
and David Gallai, Esq.

On October 22, 2004, the President signed into law the American Jobs Creation Act of 2004 (the "Jobs Act").¹ The Jobs Act added a new §409A to the Internal Revenue Code of 1986, as amended (the "Code"), which imposes strict requirements on the deferral, payment and funding of deferred compensation and severe tax consequences on the failure to meet such requirements.²

On December 20, 2004, the Department of the Treasury and the Internal Revenue Service

* Marjorie M. Glover is Chair of Chadbourne & Parke LLP's Executive Compensation and Employee Benefits Group. Sarah C. Richards and David Gallai are senior attorneys in Chadbourne's Executive Compensation and Employee Benefits Group.

¹ American Jobs Creation Act of 2004, P.L. 108-357.

² P.L. 108-357, §885.

(IRS) issued Notice 2005-1 (the "Notice"),³ which provides key guidance on certain aspects of Code §409A ("409A"). The Notice is written in question-and-answer format and is the first in a series of guidance expected to be issued in 2005.⁴ This article summarizes the main points of the Notice and assumes the reader is familiar with the requirements of 409A generally.⁵

I. HIGHLIGHTS OF THE NOTICE

The Notice provides transitional relief, generally until the end of 2005, to give companies time to bring their plan documents into compliance with 409A and participants time to cancel or terminate plan participation.⁶ The Notice

³ Notice 2005-1, 2005-2 I.R.B. 274. The Notice also provides guidance on information reporting and wage withholding. The Notice does not, however, provide significant guidance on certain aspects of 409A, including, for example, guidance on deferral elections, payment options, offshore and springing rabbi trusts (trusts that become irrevocable upon an adverse change in the company's financial health) and how amounts are taxed under 409A. See §409A(a)(1) and (b)(3)-(4) for more information.

⁴ See Notice, at p. 1.

⁵ The Notice uses the terms "service providers" and "service recipients." For simplification, this article refers to service providers as participants and service recipients as companies.

⁶ Notice, at Q&As-19(a) and 20.

TAX MANAGEMENT INC.
WASHINGTON, D.C.

also sets forth basic rules,⁷ defines certain terms (such as nonqualified deferred compensation plan,⁸ change in control,⁹ and substantial risk of forfeiture¹⁰), provides a much welcomed exemption for certain public company stock appreciation rights (“SARs”) and temporary relief for certain other SARs,¹¹ and clarifies rules related to acceleration of benefits,¹² grandfathered amounts,¹³ and material modifications.¹⁴

II. EFFECTIVE DATE AND TRANSITIONAL RULES

A. Effective Date

The requirements of 409A are generally effective for: (1) amounts deferred after December 31, 2004 (and earnings thereon) under “nonqualified deferred compensation plans;” and (2) amounts deferred before January 1, 2005 (and earnings thereon) under nonqualified deferred compensation plans that are “materially modified” after October 3, 2004.¹⁵ The Notice clarifies that amounts are considered deferred before January 1, 2005 if the participant: (1) has a legally binding right to be paid the amount; and (2) the right to the amount is earned and vested.¹⁶ For this purpose, an amount is considered earned and vested before 2005 only if the amount is not subject to either a substantial risk of forfeiture (as defined under Code §83 principles) or the requirement to perform further services.¹⁷ Amounts that are deferred before January 1, 2005, under a nonqualified deferred compensation plan that is not materially modified after October 3, 2004, are for ease of reference referred to as “grandfathered amounts,” and such nonqualified deferred compensation plans are referred to as a “grandfathered plans.”

B. Operational Compliance

Beginning January 1, 2005, companies must operate nonqualified deferred compensation plans subject to 409A in good faith compliance with 409A and the Notice.¹⁸

C. Plan Amendments

Companies have until December 31, 2005, to amend their nonqualified deferred compensation plans

to bring them into compliance with 409A with respect to amounts subject to 409A.¹⁹ Companies may also choose to amend a grandfathered plan to meet the requirements of 409A, as long as such amendment is made before December 31, 2005, and the grandfathered plan is operated in good faith compliance with 409A before the date of the amendment.²⁰

D. Plan Terminations

Companies have until December 31, 2005, to terminate nonqualified deferred compensation plans, without incurring additional taxation and penalties under 409A, as long as all amounts deferred under the plan are included in each participant’s income in the taxable year in which the termination occurs.²¹ The Notice provides that an amendment to terminate an otherwise grandfathered plan made on or before December 31, 2005, will not be considered a material modification.²² If a nonqualified deferred compensation plan is terminated after 2005, such termination would be considered to be an impermissible acceleration of benefits resulting in adverse tax consequences under 409A. The Notice provides a limited exception for plan terminations in connection with a change in control.²³

E. Deferral Elections

Companies may allow participants to make deferral elections on or before March 15, 2005, for amounts that have not been paid or become payable at the time of the election.²⁴ This provision only applies to written plans in effect on December 31, 2004 that (1) identify a specific amount or type of compensation, and (2) permit the deferral of such compensation.²⁵ This provision enables participants to defer receipt of certain 2004 bonuses payable in 2005, 2005 bonuses that would not otherwise meet the performance-based

⁷ *Id.* at Q&As-1 and 2.

⁸ *Id.* at Q&A-3.

⁹ *Id.* at Q&As-11, 12, 13 and 14.

¹⁰ *Id.* at Q&A-10.

¹¹ *Id.* at Q&A-4(d)(iv).

¹² *Id.* at Q&A-15.

¹³ *Id.* at Q&A-17.

¹⁴ *Id.* at Q&A- 18.

¹⁵ See P.L. 108-357, §885(d); Notice, at Q&A-16(a).

¹⁶ Notice, at Q&A-16(b).

¹⁷ *Id.*

¹⁸ *Id.* at Q&A-19(a)-(b).

¹⁹ *Id.* at Q&A-19(a)(ii).

²⁰ *Id.* at Q&A-19(a)-(b). During an American Bar Association Teleconference held on January 6, 2005, it was noted that if a company chooses to amend a “grandfathered plan” to bring it into compliance with 409A but does not operate the plan in full compliance with 409A during 2005 (for example, the company allows an impermissible acceleration of benefits otherwise permitted under such grandfathered plan), then the participant in the plan may be subject to taxes and penalties under 409A. Teleconference: *Treasury Guidance on 409A: Q&As with Government Officials*, sponsored by the American Bar Association Joint Committee on Employee Benefits (Jan. 6, 2005) (the “ABA Teleconference”).

²¹ Notice, at Q&A-18(c).

²² *Id.* It appears that if a grandfathered plan is terminated after 2005, such termination would be a material modification which would subject the plan to 409A. However, it is hoped that Treasury and IRS will issue additional guidance to clarify whether grandfathered plans that reserve the right to terminate such plans would be subject to such restriction on termination.

²³ *Id.* at Q&A-11-(a).

²⁴ *Id.* at Q&A-21.

²⁵ *Id.*

exception to the deferral timing rules, and 2005 salary earned after the date of the election.

F. Other Participant Elections

Until the end of 2005, companies may amend their nonqualified deferred compensation plans to allow participants during 2005 to terminate participation in or cancel their deferral elections with respect to amounts subject to 409A, as long as the participants include the amounts subject to the cancellation or termination in income in the year in which it is earned and vested.²⁶ This amendment may be made selectively to one or more participants or to one or more plans.²⁷ In addition, before the end of 2005, companies may amend their plans to allow participants during 2005 to elect to change the time and form of payment of amounts previously deferred.²⁸ Each of these amendments is optional.

G. Conforming Equity Arrangements

Until the end of 2005, companies may replace non-conforming stock options or SARs otherwise subject to 409A with stock options and SARs that meet the requirements of (or are otherwise exempt from) 409A.²⁹ For example, companies may replace stock options that have a below-market (at grant) exercise price with stock options that have a fair market value exercise price (at the original date of grant) or may amend stock or cash-settled SARs to provide for payments on the vesting date.³⁰

H. Linked Plans

Until the end of 2005, companies may continue to link the time and form of benefit payments under a nonqualified deferred compensation plan to the time and form of benefit payments elected under a qualified pension or savings plan, provided that the linkage is made in accordance with the terms of the nonqualified deferred compensation plan in effect as of October 3, 2004.³¹ This gives companies additional time to “de-link” nonqualified and qualified pension and savings plans and gives Treasury and the IRS additional time to provide guidance on “de-linking.” It should be noted that the Notice does not provide specific relief related to *deferral of amounts* under such linked plans (other than generally by allowing changes in deferral elections until March 15, 2005 — see II, E, above). As a result, at this time, there are many unanswered questions on how to coordinate deferral elections among the linked plans during 2005.

I. Severance Plans

A nonqualified deferred compensation plan that provides severance benefits and that either (1) is

collectively-bargained or (2) does not cover “key employees”³² is not required to satisfy §409A during 2005, as long as such plan is amended to comply with 409A by December 31, 2005.³³ Benefits payable under severance pay arrangements within the meaning of §3(2)(B)(i) of ERISA³⁴ that meet certain requirements under Department of Labor regulations are considered severance pay for purposes of this exception.³⁵ This exception only applies to severance pay on account of an employee’s involuntary termination of employment.³⁶ Treasury and the IRS are seeking public comment on the treatment of severance plans under 409A.³⁷

III. BASIC RULES AND DEFINITIONS

A. 409A Generally

The Notice makes clear that 409A does not alter or affect other tax rules under the Code or common law, including, for example, the constructive receipt, cash equivalence, economic benefit or assignment of income doctrines.³⁸ In addition, arrangements subject to Code §457(f) must comply with the requirements of 409A and Code §457(f).³⁹

B. Scope of 409A

The Notice makes clear that, until further guidance is issued, 409A applies to individuals (including, for example, employees, directors and independent contractors), personal service corporations (or similar non-corporate entities) and qualified personal service corporations (or similar non-corporate entities).⁴⁰ The Notice exempts from the requirements of 409A arrangements between taxpayers all of whom are accrual method taxpayers and arrangements between companies and service providers who (1) are actively engaged in the trade or business of providing substantial services (other than as employees or directors), and (2) provide such services to two or more unre-

³² Defined under Code §416(i)(1).

³³ Notice, at Q&A-19(d).

³⁴ Employee Retirement Income Security Act of 1974, P.L. 93-406.

³⁵ Notice, at Q&A-19(d). See 29 CFR §2510.3-2(b)(1)(i), which requires that: (1) such payments are not contingent directly or indirectly upon the employee’s retiring; (2) the total amount of such payments does not exceed the equivalence of twice the employee’s annual compensation during the year immediately preceding the termination of his or her service; and (3) all payments are completed generally within 24 months of termination of service, or in the case of a limited reduction in force, within 24 months after the employee reaches normal retirement age.

³⁶ Notice, Q&A-19(d).

³⁷ *Id.* at p. 7.

³⁸ *Id.* at p. 1.

³⁹ *Id.* at Q&A-6.

⁴⁰ *Id.* at Q&A-8.

²⁶ *Id.* at Q&A-20(a).

²⁷ *Id.*

²⁸ *Id.* at Q&A-19(c).

²⁹ *Id.* at Q&A-18(d).

³⁰ *Id.*

³¹ *Id.* at Q&A-23.

lated persons.⁴¹ For example, a company's regular payments to an outside accounting firm or law firm would not be covered by 409A.⁴²

C. "Nonqualified Deferred Compensation Plan" Defined

The Notice provides that a "nonqualified deferred compensation plan" is any "plan" that provides for the "deferral of compensation," other than (1) a qualified employer plan and (2) a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan.⁴³

D. "Plan" Defined

The Notice provides that a "plan" includes any agreement, method or arrangement, including an agreement, method or arrangement that applies to one person or individual.⁴⁴ A plan may be adopted unilaterally by the company or negotiated between the company and participant.⁴⁵ The rules of 409A are applied as if a separate plan is maintained for each participant and, for certain purposes, plans of the same type are aggregated with respect to each participant.⁴⁶ Specifically, (1) all compensation deferred by a participant under all account balance plans (such as defined contribution plans) is treated as if deferred under a single account plan; (2) all compensation deferred by a participant under all non-account balance plans (such as defined benefit plans) is treated as if deferred under a single non-account balance plan; and (3) all compensation deferred by a participant under plans that are neither account balance plans nor non-account balance plans (such as equity compensation plans) is treated as if deferred under one plan. As a result, the failure to follow the requirements for one nonqualified deferred compensation plan in which a participant participates may adversely affect that participant's deferred compensation under all plans of a similar type.

E. "Deferral of Compensation" Defined

A plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances: (1) during a taxable year the participant has a "legally binding right" to the compensation; (2) such compensation has not been actually or constructively received and has not been in-

cluded in gross income; and (3) according to plan terms, the compensation is payable to or on behalf of the participant in a later year.⁴⁷ For this purpose, a participant does not have a legally binding right to compensation if the company may unilaterally reduce or eliminate the compensation after the services for which the compensation is payable have been performed, unless such unilateral reduction or elimination is dependent upon a condition that is unlikely to occur or if the unilateral discretion is unlikely to be exercised.⁴⁸ A legally binding right to compensation exists even if benefits under a nonqualified deferred compensation plan are offset by benefits provided under a qualified plan or reduced because of actual or notional losses.⁴⁹

The Notice provides a number of exceptions as to the arrangements that constitute a "deferral of compensation," including the following:

1. Short-Term Deferrals

Until further guidance is issued, amounts are not subject to 409A if they are paid within 2½ months after the later of (1) the participant's tax year, or (2) the company's fiscal year, in which the amount is vested. In each case, the participant must not be permitted to defer receipt of payment to a later period.⁵⁰ This exception provides relief for annual bonus plans that provide bonus payments within such 2½-month window and for multi-year bonus arrangements that provide payments of vested amounts within the 2½-month window. This exception does not provide relief to many companies that are unable to pay bonuses within the 2½-month window because they must wait for independent certification of financial performance.

2. Certain Stock Options

(a) *Incentive Stock Options and Employee Stock Purchase Plans.* Incentive stock options⁵¹ that have no deferral feature other than the right to exercise the option in the future are not covered by 409A.⁵² Note, however, that in some cases, if such an incentive stock option is modified, then the incentive option could become covered under 409A.⁵³ Options granted under employee stock purchase programs,⁵⁴ which typically permit employees to purchase stock up to a 15% discount at certain times during the year, are not covered by 409A.⁵⁵ This exemption does not extend to options granted under employee stock purchase plans that do not meet the requirements of Code §423.

⁴⁷ *Id.* at Q&A-4(a).

⁴⁸ *Id.*

⁴⁹ *Id.* at Q&A-4(a).

⁵⁰ *Id.* at Q&A-4(c).

⁵¹ Described in Code §422.

⁵² Notice, at Q&A-4(d)(iii).

⁵³ ABA Teleconference, fn. 20, above. In response to a question, it was noted that a material modification of an otherwise exempt option may cause the option to be covered by 409A, depending upon the facts and circumstances.

⁵⁴ Described in Code §423.

⁵⁵ Notice, at Q&A-4(d)(iii).

⁴¹ *Id.*

⁴² *Id.* The Notice provides limited guidance on arrangements between partners and partnerships. See Q&A-7.

⁴³ Notice, at Q&A-3. See Code §409A(d)(1). The Notice makes clear that Archer Medical Savings Accounts, Health Savings Accounts and medical reimbursement arrangements are not covered by 409A. Notice, at Q&A-3(c).

⁴⁴ Notice, at Q&A-9.

⁴⁵ *Id.*

⁴⁶ *Id.*

(b) *Certain Nonstatutory Stock Options.* Nonstatutory stock options (stock options that do not satisfy the requirements of Code §422) that are granted at fair market value and have no deferral feature other than the right to exercise the option in the future are not covered by §409A.⁵⁶ Such options remain subject to taxation in accordance with Code §83.⁵⁷ Note, however, that in some cases, the modification of an otherwise exempt nonstatutory stock option (for example, extending the exercise period for post-termination exercises) may subject the option to 409A.⁵⁸ The Notice also provides that, for purposes of determining the fair market value of the stock at the date of grant, “any reasonable valuation method may be used,” including, for example, the valuation methods described in Treas. Regs. §20.2031-2.⁵⁹

(c) *Substitutions of Nonstatutory Options Upon a Corporate Event.* A substitution of nonstatutory stock options for other nonstatutory stock options in connection with a corporate transaction (such as a spinoff or merger transaction) will not be treated as a grant of a new option or change in the form of payment for purposes of §409A, as long as the rules for substituting incentive stock options under Treas. Regs. §1.424-1 are followed. Those rules provide certain spread and ratio tests designed to preserve the economic elements in the option substitution.⁶⁰

3. SARs

(a) *Certain Publicly-Traded Stock-Settled SARs.* SARs of publicly-traded companies are exempt from coverage if: (1) the SAR exercise price is never less than the fair market value of the underlying stock on the date the SAR is granted; (2) the underlying stock is traded on an “established securities market;” (3) the SAR is settled in company stock rather than in cash (or other property); and (4) the SAR has no deferral feature other than the right to exercise the SAR. The right to receive substantially unvested stock is not considered to be an impermissible deferral feature.⁶¹

(b) *Certain SARs Granted Pursuant to Pre-October 4, 2004 Plans.* Until further guidance is issued, a SAR (or an economically equivalent right) settled in stock or cash, or the cancellation of a SAR, is exempt from coverage under 409A if: (1) the SAR was granted under a program in effect before October 4, 2004; (2) the SAR exercise price is never less than the fair market value on the date of grant; and (3) the SAR has no deferral feature other than the right to exercise the SAR.⁶²

(c) *Fixed-Payment SARs.* New SARs may be structured to comply with 409A if payment under the SAR

will be made on a fixed payment date, rather than upon exercise by the participant.⁶³

4. Restricted Property

Receipt of restricted stock or other restricted property (such as a transfer of a beneficial interest in a trust or annuity plan) generally is not considered a deferral of compensation subject to 409A, even if taxation is delayed, because the property is nontransferable and subject to a substantial risk of forfeiture.⁶⁴

5. Other Issues Related to Equity Arrangements

In the Notice, Treasury and the IRS express concern regarding the potential for abuse of SARs and other equity arrangements settled in cash.⁶⁵ Particular concern was raised with respect to repurchase arrangements (where stock acquired by the participant is repurchased by the company) involving stock of privately-held companies.⁶⁶ Treasury and the IRS also expressed concern regarding “tandem arrangements.”⁶⁷

F. “Substantial Risk of Forfeiture” Defined

Deferred compensation is included in the gross income of a participant unless the deferred compensation is subject to a “substantial risk of forfeiture” and has not been previously included in the participant’s gross income.⁶⁸ The Notice provides that compensation is subject to a substantial risk of forfeiture if: (1) entitlement to the amount is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation (for example, the attainment of a prescribed level of earnings); and (2) the possibility of forfeiture is substantial.⁶⁹ If the service period has already begun and a condition that imposes a substantial risk of forfeiture is added with respect to such compensation, or if the period during which the compensation is subject to a substantial risk of forfeiture is extended, then such addition or extension is disregarded in determining whether the deferred compensation is subject to a substantial risk of forfeiture.⁷⁰ The Notice clarifies that compensation will not be considered to be subject to a substantial risk of forfeiture merely because it is conditioned upon the participant’s compliance with a

⁶³ *Id.* at Q&A-4(d)(i).

⁶⁴ *Id.* at Q&A-4(e).

⁶⁵ *Id.*, Part I.B.

⁶⁶ *Id.*

⁶⁷ *Id.* However, in the ABA Teleconference held on January 6, 2005, it was noted that such concern does not extend to tandem SARs which consist of a stock option that is otherwise exempt from 409A and a SAR that is otherwise exempt from 409A. ABA Teleconference, fn. 20, above.

⁶⁸ Code §409A(a)(1).

⁶⁹ Notice, at Q&A-10(a). Note that the definition of “substantial risk of forfeiture” under Code §83 is similar but not identical to the definition under Q&A-10 of the Notice.

⁷⁰ Notice, at Q&A-10(a).

⁵⁶ *Id.* at Q&A-4(d)(ii).

⁵⁷ Code 26 §83(a).

⁵⁸ ABA Teleconference, fn. 20, above.

⁵⁹ Notice, at Q&A-4(d)(ii).

⁶⁰ *Id.*

⁶¹ *Id.* at Q&A-4(d)(iv).

⁶² *Id.*

non-competition provision.⁷¹ Salary deferrals may generally not be made subject to a substantial risk of forfeiture.⁷² A deferred bonus may be considered subject to a substantial risk of forfeiture if the participant may elect to receive a materially greater bonus in the future instead of a materially lesser bonus in an earlier year. Where the participant is a significant owner of the business, the specific facts and circumstances need to be reviewed to determine if the risk of forfeiture of that participant's compensation is in fact both realistic and "substantial."

G. "Change in Control" Defined

Code §409A permits distributions from a nonqualified deferred compensation plan only under the following circumstances: (1) separation from service; (2) death; (3) disability; (4) after a specified time or under a fixed schedule; (5) upon a "change in control;" or (6) because of an unforeseeable emergency.⁷³ A "change in control" is defined in a manner similar to the way in which it is defined for golden parachute excise tax purposes under Code §280G⁷⁴ and relates to a change in control of the ownership or effective control of a corporation or a change in the ownership of a substantial portion of the corporation's assets.⁷⁵ To qualify as a change in control event, the occurrence of the event must be objectively determinable, and any requirement that a plan administrator or board of directors certify that a change in control has occurred should be strictly ministerial and not involve discretionary authority.⁷⁶ The change in control must relate to: (1) the corporation to which the participant is providing services; (2) the corporation that is liable for payment for such services (or all corporations liable for this payment if more than one corporation is liable); or (3) to a majority shareholder of a corporation described in (1) or (2) or any corporation that is a majority shareholder of such corporation.⁷⁷ In addition, a payment will be treated as occurring upon a change in control event if the right to the payment arises as a result of a corporation's discretion under the plan's terms to terminate the plan and distribute the compensation deferred within 12 months of the change in control event.⁷⁸ At this time, the definition of change in control relates to a corporation and does not extend to partnerships or other non-corporate entities.⁷⁹

There are a number of issues relating to the application of 409A requirements to change in control agreements for corporate executives. For example,

many change in control agreements include a "double-trigger," where payment is made only if the executive is terminated within a specified time after a change in control occurs. In the ABA Teleconference held on January 6, 2005, Treasury and IRS representatives informally expressed the view that the "six-month wait" rule for key employees of public companies should not be circumvented by designating the triggering event as a "change in control" rather than the "separation from service."⁸⁰

H. "Performance-Based Compensation" Defined

Section 409A generally requires deferral elections to be made before the year in which the services to which the compensation relates are performed, except where such compensation is "performance-based compensation."⁸¹ In that case, the election may be made up to six months before the end of the performance period.⁸² The Notice states that Treasury and the IRS anticipate issuing guidance that clarifies the requirements for performance-based compensation.⁸³ Until that guidance is issued, the Notice provides that performance-based compensation is compensation: (1) that is payable for services performed over a period of at least 12 months; (2) the payment or amount of which is conditioned upon satisfying certain organizational or individual performance criteria; and (3) with respect to which the performance criteria are not "substantially certain" to be met at the time of the election to defer the compensation.⁸⁴ Performance-based compensation may include payments based upon subjective criteria related to the performance of the organization or individual. Whether the subjective criteria are satisfied must not be determined by the participant or a family member of the participant.⁸⁵

IV. ACCELERATION OF BENEFITS

Generally, a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of any payments under the plan.⁸⁶ This change effectively eliminates the use of "haircut" provisions (where a participant agrees to receive a reduced benefit in exchange for an earlier distribution).

The Notice provides the following exceptions to the general prohibition on acceleration of benefits: (1) payments made pursuant to a domestic relations order (as defined in Code §414(p)(1)(B)); (2) payments made to comply with a certificate of divestiture (as defined in Code §1043(b)(2)); (3) payments made under a Code §457(f) plan (for tax-exempt and govern-

⁷¹ *Id.*

⁷² *Id.*

⁷³ §409A(a)(2)(A).

⁷⁴ See Treas. Regs. §1.280G-1, Q&As-27, 28 and 29.

⁷⁵ Notice, at Q&As-11, 12, 13 and 14.

⁷⁶ *Id.*

⁷⁷ *Id.* at Q&A-11(b).

⁷⁸ *Id.* at Q&A-11(a).

⁷⁹ *Id.* at Q&As-11, 12, 13 and 14.

⁸⁰ ABA Teleconference, fn. 20, above.

⁸¹ §409A(a)(4).

⁸² §409A(a)(4)(B)(iii).

⁸³ Notice, at Q&A-22.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ §409A(a)(3).

mental entities) to pay income taxes due upon vesting; (4) de minimis payments (not greater than \$10,000) made to a participant upon the cashout of his or her entire interest under the plan; (5) cashout payments made with respect to future deferrals if the value of the participant's account is less than an amount specified in the plan; (6) payments made to pay the Federal Insurance Contributions Act ("FICA") tax (Social Security and Medicare taxes) imposed on any compensation deferred under the nonqualified deferred compensation plan (including taxes imposed on the FICA payment); and (7) waivers or accelerations by the company of a condition that constitutes a substantial risk of forfeiture by the company, provided that the requirements of 409A are otherwise satisfied with respect to such deferred compensation (for example, if a benefit vests after 10 years of service and the company amends the nonqualified deferred compensation plan unilaterally to shorten the vesting schedule to five years, then the accelerated vesting would not be treated as a prohibited acceleration of the time or schedule of payments under §409A).⁸⁷

V. GRANDFATHERED BENEFITS

As noted in II, A, above, amounts (and earnings thereon) are considered deferred before January 1, 2005, and therefore grandfathered if: (1) the participant has a "legally binding right" to be paid the amount, and (2) the right to the amount is earned and vested (generally not subject to a substantial risk of forfeiture or a requirement to perform further services).⁸⁸ Grandfathered amounts may remain exempt from 409A as long as the grandfathered plan is not "materially modified" after October 3, 2004.⁸⁹

A. "Material Modification" Defined

A "material modification" of a nonqualified deferred compensation plan is any enhancement of a benefit or right that existed in the plan as of October 3, 2004.⁹⁰ The grant of a new benefit under an existing arrangement as of October 3, 2004, is considered to be a material modification, unless the grant is consistent with past compensation practices (such as, for example, annual grants of stock options each November).⁹¹

The Notice clarifies that a material modification will not be deemed to have occurred if: (1) the participant may choose the payment form or the time of payment if such provisions were already in the plan as of October 3, 2004; (2) the participant exercises any right under the plan that existed as of October 3, 2004; (3) there is a change in the notional investment measures for the plan; or (4) the plan is amended to

add a detriment to the participant.⁹² In addition, an amendment to a plan to conform the plan to the requirements of 409A is not a material modification, unless the amendment adds a right, even if that right is permissible under 409A.⁹³ For example, if a nonqualified deferred compensation plan does not permit distributions in the event of an unforeseeable emergency and is amended to add that right, then that amendment would be treated as a material modification, even though 409A permits payment in the event of unforeseeable emergencies.⁹⁴ This aspect of the Notice may make it more advantageous to "freeze" current nonqualified plans and establish new plans rather than amend current plans. It is not necessary, however, to establish a different nonqualified deferred compensation plan document for amounts covered under 409A, as long as the different rules for grandfathered and nongrandfathered portions of the plan are clearly stated in the document and clear accounting records are maintained regarding the amounts subject and not subject to 409A.⁹⁵

B. Determining the Amount of Grandfathered Benefits

The Notice describes how to determine the amount of compensation deferred before January 1, 2005, under a grandfathered plan.⁹⁶

1. Nonaccount Balance Plans

The amount deferred is equal to the present value as of December 31, 2004, of the amount to which the participant would be entitled if he or she voluntarily terminated employment (or services) without cause on December 31, 2004, and received a full payment from the plan at the earliest possible date permitted by the plan following such termination, to the extent the right to the benefits are earned and vested as of December 31, 2004. Note that early retirement subsidies to which a participant was not entitled as of December 31, 2004, are not part of the grandfathered benefits.⁹⁷

2. Account Balance Plans

The amount deferred is equal to the portion of the participant's account balance on December 31, 2004, that is earned and vested (including post-December 31, 2004 earnings thereon).⁹⁸

3. Equity-Based Plans

The rule for determining amounts deferred under account balance plans is used for equity-based plans,

⁹² *Id.* at Q&A-18.

⁹³ *Id.*

⁹⁴ *Id.* at Q&A-18(a).

⁹⁵ ABA Teleconference, fn. 20, above. In response to a question, it was noted that a nonqualified deferred compensation plan may consist of grandfathered and non-grandfathered portions using the same plan document, as long as the amounts are accounted for separately.

⁹⁶ Notice, at Q&A-17.

⁹⁷ *Id.* at Q&A-17(a).

⁹⁸ *Id.* at Q&A-17(b) and (d).

⁸⁷ Notice, at Q&A-15.

⁸⁸ See P.L. 108-357, §885(d); Notice, at Q&A-16(b).

⁸⁹ Notice, at Q&A-16(a).

⁹⁰ *Id.* at Q&A-18(a).

⁹¹ *Id.* at Q&A-18(b).

except that any amount that must be paid by a participant (such as an exercise price) is subtracted. An increase in the amount of this payment after December 31, 2004, due to the appreciation of the underlying equity is considered to be an amount deferred before January 1, 2005.⁹⁹

VI. CONCLUSION

Treasury and the IRS have issued the first in a series of much needed guidance on 409A and are ex-

pected to issue additional guidance on 409A throughout 2005. Although companies have until the end of 2005 to amend nonqualified deferred compensation plan documents to comply with 409A, such plans must be operated in compliance with 409A now. Accordingly, companies must act quickly to ensure that plans subject to 409A are being operated in compliance with the new law and must develop a plan of action to bring plans into compliance with the new law by the end of this year. Companies must also implement safeguards to ensure that grandfathered plans are not inadvertently “materially modified” and made subject to 409A.

⁹⁹ *Id.* at Q&A-17(c).