

Client Alert

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

The Treasury Department and the Internal Revenue Service has issued Notice 2005-1 (the "Notice"), which provides key guidance on the new nonqualified deferred compensation law enacted by the American Jobs Creation Act of 2004 (the "Jobs Act"). The Jobs Act added Section 409A to the Internal Revenue Code (the "Code") (see our Client Alert dated October 14, 2004). Code Section 409A imposes strict new timing rules on the payment of nonqualified deferred compensation to employees, directors and certain other service providers and provides unfavorable tax consequences for the failure to comply with the new law. The Notice clarifies that the new law applies in addition to existing tax rules governing nonqualified deferred compensation arrangements such as constructive receipt, cash equivalency, economic benefits, assignment of income and other statutory and common law doctrines.

The Notice is the first in a series of guidance. Additional guidance is expected to be issued by mid-2005.

Highlights

The Notice:

- gives companies until December 31, 2005 to amend or terminate their plans;
- gives participants until March 15, 2005 to make deferral elections under an existing plan in accordance with that plan's terms for amounts that have not been paid or become payable at the time of the election, and until December 31, 2005 to cancel a deferral election or to terminate plan participation;
- clarifies basic rules and defines a number of terms, including, for example, nonqualified deferred compensation plan, deferred compensation, change in control, and substantial risk of forfeiture;
- provides welcome relief from the new law for certain stock appreciation rights ("SARs") issued by public companies (and limited relief for certain other SARs until further guidance is issued);
- casts doubt on the viability of many other forms of equity-based compensation, such as tandem stock options/SARs; and
- clarifies rules related to acceleration of benefits, grandfathered benefits, material modifications and wage withholding and reporting requirements.

The Notice addresses many other key issues only briefly (or not at all), including deferral elections, payment options, offshore and springing rabbi trusts and how amounts are taxed under the new law.

Effective Dates

The new law covers amounts deferred after December 31, 2004 and amounts deferred before January 1, 2005 if the plan is materially modified after October 3, 2004. An amount is deferred before January 1, 2005 if the participant has a legally binding right to be paid such amount and the right to the amount is earned and vested before such date. Amounts that are unvested as of December 31, 2004 are considered deferred after December 31, 2004, regardless of whether the plan under which they were deferred is materially modified.

Transition Periods

Plan Amendments. Companies have until December 31, 2005 to amend their plans to comply with the new law.

Plan Terminations. Companies have until December 31, 2005 to terminate plans and pay out benefits from such plans, as long as the amounts of deferred compensation are includible in income in the year of the termination. After December 31, 2005, the new law generally prohibits companies from terminating plans and paying out benefits as a result of the termination, except in certain cases.

Deferral Elections. For plans in existence before 2005, participants have until March 15, 2005 to make deferral elections in accordance with plan terms for amounts that have not been paid or become payable at the time of the election.

Other Elections. Until December 31, 2005, companies may (but are not required to) amend their plans to allow participants to cancel their deferral elections or to terminate participation in the plan as long as the participants include the amounts subject to the cancellation in gross income. Companies may selectively apply these amendments to some plans and some participants.

Non-Conforming Equity Arrangements. Until December 31, 2005, it will not be a material modification of a grandfathered plan for a company to replace non-conforming stock options and SARs otherwise subject to the new law with stock options and SARs that meet the requirements of (or are exempt from) the new law. 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 or may amend SARs to provide for payments on the vesting date.

Continued Linkage to Qualified Plans Permitted Through 2005. Until December 31, 2005, the form of payment (*e.g.*, a lump sum or an annuity) under a nonqualified deferred compensation plan (such as a supplemental retirement plan or an excess savings plan) subject to the new law may continue to be linked to the form of payment elected under an underlying qualified pension or savings plan, provided that the linkage complies with the terms of the nonqualified plan in effect as of October 3, 2004.

Certain Severance Plans Exempt from Coverage Through 2005. A plan that provides severance benefits that are collectively-bargained or that does not cover “key employees” does not need to comply with the requirements of the new law until 2006. Benefits payable under severance plans that meet certain ERISA requirements (*i.e.*, total severance pay not in excess of 24 months of compensation and paid out within 24 months of termination) are considered severance pay for purposes of this exception. This exception applies only to benefits payable on account of involuntary terminations.

Operational Compliance. During 2005, companies must operate their plans in good faith compliance with the new law, the Notice and any later Treasury and IRS guidance. To the extent that any later guidance is less favorable, Treasury and IRS intend to apply the less favorable rules prospectively and will provide time for companies to comply with the less favorable rules.

Basic Rules and Definitions

The new law generally applies to any “plan” that provides for the “deferral of compensation.” 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. The new law contains rules limiting the circumstances in which advance distributions of deferred compensation can be made, including “change in control” situations. The new law generally requires deferral elections to be made before the year in which the compensation is earned, except where such compensation is “performance based compensation.” In that case, the election may be made up to six months before the end of the performance period.

Plan. “Plan” has a very broad meaning that includes any agreement, method or arrangement between one or more persons. This means that an employment contract could constitute a plan for these purposes. Plans do not need to be negotiated; they can be unilaterally adopted by the employer or service recipient.

- Each Participant is Deemed to Participate in a Separate Plan. Even if a plan covers more than one person, each person is treated as if he or she participates in a separate plan for purposes of the new law. As a result, the new rules are violated in a particular circumstance only with respect to one participant; the other plan participants are unaffected.
- Aggregation of the Same Type of Plans Covering the Same Participant. Each type of plan with respect to a particular participant is aggregated with other plans of the same type for purposes of determining whether the requirements of the new law are satisfied. This means that: (1) all compensation deferred by a participant under all account plans is treated as if deferred under a single account plan; (2) all compensation deferred by a participant under all nonaccount plans is treated as if deferred under a single nonaccount plan; and (3) all compensation deferred by a participant under a plan that is neither an account plan nor a nonaccount plan is treated as if deferred under one plan. Failure to follow the requirements for one plan in which a participant participates taints all plans of a similar type covering that participant.

Deferred Compensation. Generally, deferred compensation is compensation that a participant has a legally binding right to receive in one year that will be paid in a later year. No deferral is deemed to occur if the company (or another person) may unilaterally reduce or eliminate the compensation. However, Treasury and IRS may disregard discretion to reduce or eliminate compensation if they determine that such discretion is unlikely to be exercised.

Substantial Risk of Forfeiture. 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. If the service period has already started 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 the deferred compensation is not considered to be subject to a substantial risk of forfeiture.

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 non-competition provision. Salary deferrals may generally not be made subject to a substantial risk of forfeiture. A bonus may be deferred and subjected to a substantial risk of forfeiture if an election is provided to the participant to receive a materially greater bonus in the future rather than 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 realistic and "substantial."

Change in Control. The Notice defines "change in control" in a manner similar to the way in which it is defined for golden parachute excise tax purposes. To qualify as a change in control event, the occurrence of the event must be objectively determinable and cannot be solely deemed a change in control event by a plan administrator or board of directors. 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 twelve months of the change in control event.

Timing of Deferral Elections -- Special Rule for Performance Based Compensation. As noted, the new law contains a special timing rule for deferral elections for performance based compensation. Performance based compensation is compensation payable for services performed over a period of at least twelve months where payment of the compensation is contingent on organizational or individual performance criteria, the payment of which must not be substantially certain at the time of the election to defer the compensation. Performance based compensation may include payments based upon subjective criteria, but the subjective criteria must relate to the performance of one or more participants or business units. Whether the subjective criteria are satisfied must not be determined by the participant or a family member of the participant. This means that closely-held corporations should establish objective performance criteria for bonuses.

Arrangements Subject (and Not Subject) to the New Law

The Notice clarifies what arrangements are (and are not) subject to the new law.

Equity Arrangements

SARs of Publicly Traded Companies. SARs of publicly-traded companies are exempt if: (1) the SAR exercise price may never be 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 such-traded employer stock rather than in cash (or other property); and (4) the SAR has no discount element or deferral feature other than the right to exercise the SAR. The right to receive substantially unvested stock is not considered an impermissible deferral feature.

Temporary SARs Relief for Pre-10/4/04 Programs. 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 if: (1) the SAR was granted under programs in effect on or before October 3, 2004; (2) the SAR exercise price may never be less than the fair market value on the date of grant; and (3) the SAR has no discount feature or deferral feature other than the right to exercise the SAR. It remains unclear whether this exception is limited to SARs granted on or before October 3, 2004 under such programs.

SARs with Fixed Payment Dates. SARs may be structured to comply with the new law if payment under the SAR will be made on a fixed payment date, rather than upon exercise by the participant.

Tandem Options/SARs. Tandem arrangements, awards of options and SARs, either as alternative or supplemental awards, are treated as deferred compensation arrangements. This may adversely impact the continued viability of tandem options/SARs. Note that if a stock option includes a tandem SAR, the stock option/tandem SAR would be covered by the new law, even if the exercise price for the stock option/tandem SAR is the fair market value on the date of grant.

Flexible Valuation Rules for Privately-Held Companies. Privately-held companies are permitted to determine value for stock options under “any reasonable valuation method,” for example, valuation methods set out in the estate tax regulations. This should provide privately-held companies greater flexibility in complying with the new law.

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 the new law, even if taxation is delayed, because the property is nontransferable and subject to a substantial risk of forfeiture.

Stock Option Adjustments in Spin-Offs or Mergers. Substitution of non-statutory options in connection with a corporate transaction (such as spin-offs and merger transactions) will not be treated as a grant of a new option or change in the form of payment for purposes of the new law, as long as the rules for substituting incentive stock options under Treasury Regulation Section 1.424-1 are followed. Those rules provide certain spread and ratio tests designed to preserve the same economic elements in the option substitution.

Other Arrangements

Exempt Arrangements. The following arrangements are exempt from the new law: qualified plans; certain bona fide vacation, sick leave, compensatory time, disability pay and death benefit plans; and benefits such as Archer Medical Savings Accounts, Health Savings Accounts and medical reimbursement arrangements under cafeteria plans.

Year-End Bonuses. Bonuses will not be subject to the new law if 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 beyond the payment date stated in the plan.

Multi-Year Compensation Arrangements. Multi-year compensation arrangements that provide for delayed vesting are exempt, as long as the compensation is paid promptly after the amount is vested. An amount is considered to be paid promptly after vesting if it is paid within 2½ months after the participant’s or the company’s tax year in which the award vests. This exemption only applies if the participant cannot elect to defer payment to a later year. For example, if a long-term incentive plan provides for payments that vest at the end of a three-year cycle and payments are made within 2½ months after the amounts vest, then the plan would not be subject to the new law.

Routine Service Provider Payments. The new law does not apply to arrangements between accrual method taxpayers. In addition, the new law does not apply to arrangements with participants who provide services (other than as an employee or director) to two or more unrelated persons. For example, a company’s regular payments to an outside accounting firm or law firm would not be covered under the new law.

Acceleration of Benefits

Subject to certain exceptions, the new law prohibits the acceleration of benefit payments under a nonqualified deferred compensation plan.

The Notice clarifies that the following payments do not constitute a prohibited acceleration of benefits under the new law:

- payments pursuant to a qualified domestic relations order;
- payments necessary to comply with federal conflict of laws, such as a certificate of divestiture;
- payments under a 457(f) plan (for tax-exempt and governmental entities) to pay income taxes due upon vesting;
- *de minimis* payments (no more than \$10,000) made to a participant upon the cash-out of his or her entire interest under the plan;
- cash-out payments made with respect to future deferrals if the value of the participant's account is less than an amount specified in the plan;
- payments necessary to pay the FICA tax imposed on any compensation deferred under the plan (including taxes imposed on the FICA payment); and
- waivers or accelerations of a condition that constitutes a substantial risk of forfeiture. For example, if a benefit vests after ten years of service and the plan unilaterally reduces the vesting schedule to five years, that accelerated vesting is not treated as a prohibited acceleration of benefits and is permissible under the new law.

Note that a grandfathered plan (see below) may not accelerate vesting without causing the plan to lose its grandfathered status and become covered under the new law because such acceleration will be treated as a material modification.

Grandfathered Benefits

As stated above, the new law does not generally apply to amounts deferred under pre-2005 plans if such plans have not been "materially modified" after October 3, 2004 (so-called "grandfathered benefits").

Material Modifications. A material modification of a plan is any enhancement of a benefit or right that existed as of October 3, 2004. Accelerated vesting constitutes a material modification. The grant of a new benefit under an existing arrangement as of October 3, 2004 is also considered to be a material modification unless the grant is consistent with past compensation practices (such as annual grants of stock options each November).

The following are not considered material modifications:

- the exercise of discretion by a participant to choose the payment form or the time of payment if the provisions of the plan as of October 3, 2004 permit a participant such discretion;
- a change in the notional investment measures or exercise of any right under the terms of a plan existing as of October 3, 2004;
- a plan amendment to a plan to add a detriment to a benefit or right; and

- an amendment to a plan to conform the plan to the requirements of the new law (unless the amendment adds a right, even if such right is permissible under the new law). For example, if the plan does not permit distributions in the event of unforeseeable emergencies and is amended to add that right, the amendment would be treated as a material modification even though the new law permits payment in the event of unforeseeable emergencies.

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.

- Nonaccount Balance Plans. The amount deferred is equal to the present value as of December 31, 2004 of the benefit that a participant would receive if he or she voluntarily terminated employment (or services) without cause on that date and received a full payment from the plan at the earliest possible date permitted by the plan following such termination, to the extent such benefits are earned and vested as of December 31, 2004. Note that early retirement subsidies to which participants were not entitled as of December 31, 2004 are not part of the grandfathered benefits.
- 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 associated earnings).
- Equity-Based Plans. The rule for determining amounts deferred under account balance plans is used for equity-based plans, 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.

Reporting and Withholding

The new law requires that all deferrals made after December 31, 2004 (and earnings on those deferrals) under a nonqualified deferred compensation plan be reported separately on Form 1099-MISC or on Form W-2, depending on whether the individual is an independent contractor or an employee. (Deferrals made before January 1, 2005 do not need to be reported.) Until further guidance is issued, nonaccount plans do not need to report amounts deferred under such plans if the amounts are not reasonably ascertainable. Until further guidance is issued, if amounts deferred under all plans do not exceed \$600 per participant for a particular year, such amounts do not need to be reported. Beginning in 2005, if an amount is included in gross income on account of the new law, it is subject to wage withholding.

* * * * *

The Notice provides a starting point to help you evaluate your nonqualified deferred compensation programs. We would be happy to work with you in evaluating your current nonqualified deferred compensation programs in light of the new law and in amending existing plans or establishing new plans to comply with the new law.

* * * * *

December 20, 2004

For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, on our website at www.chadbourne.com/publications/sub_Publications.html. Our client alerts are for general informational purposes and should not be regarded as legal advice. If you have any questions regarding Code Section 409A or the Notice, please contact any of the following:

New York

George E. Zeitlin	+1 (212) 408-5311	gzeitlin@chadbourne.com
Edward P. Smith	+1 (212) 408-5371	esmith@chadbourne.com
William G. Cavanagh	+1 (212) 408-5388	wcavanagh@chadbourne.com
Marjorie M. Glover	+1 (212) 408-1016	mglover@chadbourne.com
Lauren D. Kelly	+1 (212) 408-5520	lkelly@chadbourne.com
Sarah C. Richards	+1 (212) 408-5426	srichards@chadbourne.com
David Gallai	+1 (212) 408-1003	dgallai@chadbourne.com

Chadbourne & Parke LLP

<p>New York 30 Rockefeller Plaza New York, New York 10112 Telephone: +1 (212) 408-5100 Facsimile: +1 (212) 541-5369</p>	<p>Washington, D.C. 1200 New Hampshire Avenue, N.W. Washington, D.C. 20036 Telephone: +1 (202) 974-5600 Facsimile: +1 (202) 974-5602</p>
<p>Los Angeles 350 South Grand Avenue, Suite 3300 Los Angeles, CA 90071 Telephone: +1 (213) 892-1000 Facsimile: +1 (213) 622-9865</p>	<p>Houston 1100 Louisiana, Suite 3500 Houston, TX 77002 Telephone: +1 (713) 571-5900 Facsimile: +1 (713) 571-5970</p>
<p>London Chadbourne & Parke (a multinational partnership) Regis House 45 King William Street London EC4R 9AN Telephone: +44 (20) 7337-8000 Facsimile: +44 (20) 7337-8001</p>	<p>Moscow 52/5 Kosmodamianskaya Naberezhnaya Moscow 115054, Russian Federation Telephone: +7 (095) 974-2424 Facsimile: +7 (095) 974-2425</p>
<p>Warsaw (through a Polish partnership) ul. Emilii Plater 53 00-113 Warsaw, Poland Telephone: +48 (22) 520-5000 Facsimile: +48 (22) 520-5001</p>	<p>Kyiv 11 Mykhailivska Street, 4th Floor Kyiv 01001, Ukraine Telephone: +380 (44) 230-2534 Facsimile: +380 (44) 230-2535</p>
<p>Beijing Beijing Kerry Centre 1 Guang Hua Road Chao Yang District Beijing 100020, China Telephone: +86 (10) 8529-8892 Facsimile: +86 (10) 8529-8866</p>	

If you would like additional copies of this client alert, please contact Phillipa Yule, Director of Marketing and Creative Services, at +1 (212) 408-5240 or e-mail: pyule@chadbourne.com.