INITIAL GUIDANCE ON NEW DEFERRED COMPENSATION RULES

The Treasury has issued initial guidance under Section 409A of the Internal Revenue Code. Section 409A, added to the Code as part of the American Jobs Creation Act of 2004, makes sweeping changes to the rules governing nonqualified deferred compensation. The initial guidance focuses primarily on definitional issues and transition rules, leaving many questions to future guidance. A number of positions taken in the initial guidance are subject to change. However, future guidance that is more restrictive will be prospective and taxpayers may rely on the initial guidance for now.

This memorandum provides a brief overview of the principal issues addressed by the guidance. While no plan amendments are required by year-end, plans subject to the new law will need to be in operational compliance beginning on January 1, 2005. As a result, companies will need to give prompt attention to the impact of the guidance on their compensation arrangements.

What does Section 409A provide?

Section 409A provides specific rules for nonqualified deferred compensation plans relating to deferral elections, distributions, funding and acceleration of benefits. Failure to comply with Section 409A generally results in immediate income inclusion of the amounts deferred, plus a 20% penalty tax.[1]

How is "nonqualified deferred compensation plan" defined?

A nonqualified deferred compensation plan is any "plan" that provides for the "deferral of compensation." A "plan" is any agreement, method or arrangement, written or otherwise, between a company and one or more "service providers," which includes employees and partners in a partnership, as well as other non employee service providers.

The new rules create three categories of plans: "account balance plans" (e.g., typical elective deferred compensation plans), "nonaccount balance plans" (e.g., defined benefit SERPs) and other plans (e.g., stock option and stock appreciation right (SAR) plans). The requirements of Section 409A are applied to each category of plan separately, and within each category (i) a separate plan (or plans) is deemed maintained for each participant and (ii) all compensation deferred with respect to a particular participant is treated as deferred under a single plan.

---

[1] For a discussion of the statutory requirements of Section 409A, see our client memorandum, "American Jobs Creation Act of 2004 Makes Sweeping Changes to Deferred Compensation Rules," dated October 29, 2004.

These provisions ensure that operational violations relating to one participant will not affect the deferrals of other participants. They also mean, however, that a violation of Section 409A with respect to a participant in one category of plan will disqualify that participant's deferrals under *all* plans of the employer in the same category (other than plans that are grandfathered), including deferrals under such plans for prior years. As a result, an employer cannot protect a participant's deferrals for prior years under a specific category of plan by implementing new, separate plans each year.

Are certain types of plans exempt from Section 409A?

Yes. Qualified retirement plans under Section 401(a) of the Code, tax-deferred annuities, simplified employee pension plans, SIMPLE plans, and eligible deferred compensation plans under Code Section 457(b), along with certain welfare benefit plans including bona fide vacation, sick leave, compensatory time, disability pay and death benefit plans, are specifically exempt from Section 409A.

What is a "deferral of compensation"?

In general. A nonqualified deferred compensation plan provides for the "deferral of compensation" only if a service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income for such year, *and* is payable to the service provider in a later year, whether by design or voluntary election. Certain customary payroll practices are not considered a deferral of compensation.

For example, compensation paid after the end of an employee's taxable year under an employer's normal payroll procedures does not constitute a deferral of compensation. Pending further guidance, a deferral of compensation does not occur if compensation is paid after the end of an employee's taxable year under a plan that requires payment to be made within 2½ months after the end of the first taxable year of the employer or the employee (whichever ends later) in which the compensation is no longer subject to a "substantial risk of forfeiture."

Equity-Based Compensation. Under the new rules, stock options, SARs and other equity-based compensation may provide for a deferral of compensation.[2]

Options. The grant of a nonstatutory stock option constitutes a deferral of compensation unless (i) the exercise price may never be less than the fair market value of the underlying stock on the date of grant and (ii) the option does not contain any separate feature for deferral of compensation.

Stock Appreciation Rights. In general, the grant of a SAR constitutes a deferral of compensation unless (i) the strike price may never be less than the fair market value of the underlying stock on

---

[2] Statutory stock options within the meaning of Section 422 or 423 of the Code do not provide for a deferral of compensation.

the date of grant, (ii) the underlying stock is traded on an established securities market, (iii) the SAR may be settled only by delivery of stock and (iv) the SAR does not contain any separate feature for the deferral of compensation.

Stock Appreciation Right Programs in effect on or prior to October 3, 2004. Pending further guidance, cash-settled SARs issued under a *program* in effect on or prior to October 3, 2004 will *not* be treated as a deferral of compensation provided (i) the strike price may never be less than the fair market value of the underlying stock on the date of grant and (ii) the SAR does not contain any separate feature for the deferral of compensation. The intended scope of this provision is not entirely clear. While there would appear to be some latitude for companies with pre-October 4, 2004 SAR plans to continue to grant cash-settled, at-the-money SARs, we recommend that new SAR grants under grandfathered plans be deferred pending further guidance.

Restricted Stock and RSUs. Unlike the grant of restricted stock (i.e., stock that is nontransferable and subject to vesting), the grant of a contractual right to receive stock at a future date (such as a restricted stock unit of "RSU") results in a deferral of compensation.

Partnership Interests. Pending further guidance, the issuance of a profits interest in a partnership in exchange for services that would not result in income inclusion at the time of issuance under existing law will not be treated as a deferral of compensation.

Are any types of service providers excluded from Section 409A?

Yes. Section 409A does not apply to service providers actively engaged in a trade or business providing services (other than as an employee or director) to two or more unrelated third parties. This provision would exclude fee arrangements between consulting, accounting and law firms, and clients of such firms.

What is a "substantial risk of forfeiture"?

As noted above, pending further guidance, Section 409A does not apply to compensation that, by its terms, must be paid within 2 ½ months after the end of the first taxable year of the employee or employer (whichever ends later) in which it is no longer subject to a "substantial risk of forfeiture."

Compensation is subject to a substantial risk of forfeiture under Section 409A if entitlement to the compensation is conditioned upon (i) the performance of substantial future services, or (ii) the occurrence of a condition *related to a purpose of the compensation*, and (in either case) the possibility of forfeiture is substantial. A condition is related to the purpose of the compensation if it relates to a service provider's individual performance, or the employer's business activities or organizational goals. Examples would include individual or company performance goals, strategic goals, and liquidity events, such as an IPO or sale of the employer.

The possibility of forfeiture may not be considered substantial where an employee owns a significant percentage of an employer's voting securities and is able to assert effective control over the employer, making the possibility of enforcement unlikely. Also, compensation is not subject to a substantial risk of forfeiture merely because payment is conditioned upon compliance with a restrictive covenant, such as a prohibition on competition with the employer.

How is "Change in Control" defined?

Deferred Compensation subject to Section 409A must be distributable only upon one or more permissible distribution events. One of the permissible events is a distribution upon a change in the ownership or effective control of the corporation maintaining the plan. Under the guidance, the definition of "change in control" is similar to the definition used under the golden parachute rules of Section 280G of the Code. Although the occurrence of a change in control must be objectively determinable, without the exercise of discretionary authority, companies are permitted to exercise discretion under the terms of a plan to terminate the plan and pay out all deferred compensation within 12 months following the change in control.

Under what circumstances is an acceleration of deferred compensation permitted?

Section 409A generally prohibits acceleration of the time or schedule of any payment under a nonqualified deferred compensation plan. Exceptions are made for payments upon a change in control or in connection with an unforeseeable emergency. A waiver or acceleration of a vesting condition is not, by itself, an acceleration of the time or schedule of a payment of deferred compensation, provided the requirements of Section 409A are otherwise satisfied with respect to the payment. For example, where a nonqualified deferred compensation plan provides for a distribution upon termination of employment and the benefit vests after 10 years of service, a reduction of the vesting period to five years is not an impermissible acceleration (since the payments can still be made only upon termination of employment). Plans may also permit an acceleration of payment to comply with a domestic relations order or a certificate of divestiture to address a conflict of interest, or to pay employment taxes.

What is the effective date of Section 409A?

Section 409A applies to (i) compensation deferred in taxable years beginning after December 31, 2004 and (ii) compensation deferred in taxable years prior to January 1, 2005 *if* the plan under which the deferral is made is materially modified after October 3, 2004 *or* the deferred amounts are not earned and vested prior to January 1, 2005. An amount is considered earned and vested only if it is not subject to a substantial risk of forfeiture or a requirement to perform further services. Amounts previously deferred and not subject to Section 409A are grandfathered.

Section 409A does not apply to *earnings* on grandfathered amounts. For a defined benefit SERP, the grandfathered amount equals the present value of the amount to which the employee would have been entitled under the SERP as of December 31, 2004, if the employee had terminated service as of such date and received full payment of his benefits. Under an equity-based compensation award, the grandfathered amount is the portion of the award that is earned and vested on December 31, 2004, including increases in value attributable to future appreciation of the employer's stock.

When is a grandfathered plan "materially modified"?

A grandfathered plan or award is materially modified if a benefit or right existing under the plan or award as of October 3, 2004 is enhanced, or a new benefit or right is added. For example, the addition of a feature to accelerate vesting under a grandfathered plan would be a material modification. It is *not* a material modification for an employer to exercise discretion over the time and manner of payment of a benefit *if* such discretion is provided under the terms of the plan as of October 3, 2004, nor is it a material modification for a participant to exercise a right permitted under any such plan. Certain changes in notional investment alternatives are also permitted.

Adoption of a New Arrangement. The adoption of a new arrangement or grant of an additional benefit under a grandfathered plan will generally be considered a material modification. There is a limited exception for additional benefits provided in accordance with an employer's historical practices.

Suspension or Termination of a Plan. Amending a grandfathered plan to stop future deferrals is *not* a material modification, nor is terminating a grandfathered plan on or before December 31, 2005 to distribute *all* deferred amounts, provided that all such amounts are included in the service provider's income in the year in which the plan is terminated. Under this provision, plan sponsors are allowed a limited period within which to terminate and pay out all amounts under any of their grandfathered deferred compensation plans.

Equity-Based Compensation. The cancellation on or before December 31, 2005 of an outstanding SAR or discount stock option that provides for the deferral of compensation and is thus subject to Section 409A, in exchange for a replacement grant that is exempt from the requirements of Section 409A, will not be a material modification, provided (i) the number of shares subject to the new grant equals the number subject to the old grant and (ii) the new grant does not provide any additional benefits.

How does the guidance treat plans adopted on or before December 31, 2005 that are not grandfathered?

General Rule. Plans adopted on or before December 31, 2005 that are not grandfathered must be maintained in good faith operational compliance with Section 409A during 2005, and the terms of such plans must be brought into full compliance on or before December 31, 2005.

Good Faith Operational Compliance. A plan is maintained in good faith operational compliance if it is administered in accordance with Treasury guidance. With respect to operational issues not addressed in such guidance, the plan must be operated in compliance with Section 409A based on a good-faith, reasonable interpretation of the statute and the legislative history. For example, if a non grandfathered plan allows for distributions subject to a 10% "haircut," a distribution to an employee under that provision would violate Section 409A and the distribution would be subject to the 20% penalty tax.

Can Section 409A apply to severance plans?

Yes, although certain severance plans for collectively bargained or rank-and-file employees are not required to meet the requirements of Section 409A during 2005, provided they are amended to comply by December 31, 2005. Treasury is expected to provide further guidance on the treatment of severance plans.

Can an existing plan be amended to allow a participant to terminate participation or cancel an outstanding deferral election?

Yes. A plan adopted on or before December 31, 2005 may be amended to allow a participant, on or before December 31, 2005, to terminate participation or cancel an outstanding deferral election provided the amounts subject to termination or cancellation are includible in income of the participant for 2005 or, if later, the taxable year in which the amounts are earned and vested. Companies are not *required* to offer participants a right to terminate participation or cancel deferrals, and such rights may be offered to participants selectively.

Can a plan participant make a late deferral election for 2004 and 2005 deferrals?

Yes. Elections for deferrals that relate to compensation for services to be performed on or prior to December 31, 2005 may be made on or prior to March 15, 2005, provided (i) the amounts to which the deferral elections relate were not paid or payable at the time of the election, (ii) the plan under which the elections are made was in existence on or before December 31, 2004, (iii) the elections are made in accordance with the terms of the plan as in effect on or before December 31, 2004, (iv) the plan is otherwise operated in accordance with Section 409A and (v) the plan is amended to comply with Section 409A by December 31, 2005.

How can annual bonuses for 2005 be deferred?

Section 409A generally requires that deferral elections be made prior to the beginning of the year in which the compensation is earned. An exception is made for compensation that is "performance-based" and payable for services to be performed over a period of at least 12 months, such as certain annual bonus compensation. Elections to defer performance-based annual bonus compensation generally may be made no later than six months before the end of the year to which the bonus relates. Pending further guidance, "performance-based compensation" means compensation that is contingent on the satisfaction of organizational or individual performance criteria, where the performance criteria are not substantially certain to be met at the time the deferral election is made.

Is any relief provided for current distribution elections tied to elections under qualified plans?

Yes. For periods ending on or before December 31, 2005, an election covering the timing and form of payment under a nonqualified deferred compensation plan that is controlled by a payment election made by a participant under a plan qualified under Section 401(a) of the Code will not violate Section 409A, provided the determination of the timing and form of payment is made in accordance with the terms of the nonqualified deferred compensation plan as in effect as of October 3, 2004.

Is deferred compensation subject to new reporting and withholding requirements?

Yes. Beginning with compensation deferred for 2005, all deferrals under a nonqualified deferred compensation plan must be reported on Forms W-2 and 1099, respectively, for the year in which the amount is actually deferred. Amounts are actually deferred in the year in which the service provider first has a legally binding right to the compensation. For example, amounts that a service provider would have a legally binding right to receive in 2005 but for a prior deferral election under a nonqualified deferred compensation plan will need to be reported in early 2006. All amounts includible in gross income under Section 409A are wages subject to income tax withholding. The Treasury expects to issue additional guidance relating to the method for calculating the amount of deferrals and the amount includible in gross income for reporting and withholding purposes.

* * * * * * * *

If you have any questions about this memorandum, please contact Frank A. Daniele at (212) 728-8216, Dwight W. Ellis at (212) 728-8218, Stephen T. Lindo at (212) 728-8242, J. Pasco Struhs at (212) 728-8109 or the partner with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

December 28, 2004

Copyright © 2004 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information.