VEDDER PRICE
Executive Compensation Group Advisory

December 23, 2004

NONQUALIFIED DEFERRED COMPENSATION GUIDANCE

The Treasury Department and the IRS released Notice 2005-1 on December 20, 2004 providing limited guidance on the new nonqualified deferred compensation tax law imposed by Internal Revenue Code Section 409A. While the guidance is not definitive and indicates that the Treasury and the IRS are still thinking through these rules, the notice helps with respect to 2005 deferred compensation planning issues. Section 409A imposes burdensome penalties on executives, employees and other "service providers" who fail to meet the stringent requirements of Section 409A, resulting in the accelerated inclusion of taxable income for non-compliant deferred compensation, plus an additional 20% penalty tax. Moreover, Section 409A impacts not only traditional deferred compensation plans, but also SERPs, cash-based and equity-based incentive programs, and severance arrangements. For executives and their companies, the major provisions of Notice 2005-1 are:

- **What to do before December 31, 2004 (and after).** Notice 2005-1 provides that a deferral election for compensation earned in 2005 may be made on or before March 15, 2005 (for amounts earned after such election) if (1) the plan was in existence on December 31, 2004 and (2) the plan is amended in 2005 to comport with Section 409A (note that these elections may be cancelled as explained later in this paragraph). Deferred amounts (and related earnings) that meet the definition of deferred compensation (see below) and deferred by December 31, 2004 are grandfathered but subject to the rules relating to post-October 3, 2004 material modification (generally, modifications that enhance or provide additional benefits). Nonqualified deferred compensation plans adopted before December 31, 2005 will not be treated as violating Section 409A for amounts deferred in 2005 if (1) the plan is operated in good faith compliance with Section 409A and Notice 2005-1 during calendar year 2005 and (2) the plan is amended by December 31, 2005 to conform with Section 409A. During 2005, a plan may be amended to allow a participant to terminate participation and/or cancel all or some of the 2005 deferrals, both prior and future amounts. Thus, Notice 2005-1 provides some "breathing room" for 2005 deferrals. Deferrals can be made through the end of 2004 (as in the past) with the understanding that these deferrals may be cancelled during 2005. Or participants may wait to elect deferrals for 2005 if made by March 15, 2005.

- **Definition of Deferred Compensation.** The test to determine whether compensation is "deferred compensation" – and thus subject to Section 409A – is whether the employee or other service provider has a legally binding right during a taxable year to the compensation (generally, the "earned and vested" test). Deferred compensation is "vested" when there is no substantial risk of forfeiture (see below). If the compensation may be unilaterally reduced by the employer/service recipient, there is no legally binding right. While this might appear that "haircuts" would still work, Treasury officials indicated that the portion that is not at risk would still be legally binding and thus treated as deferred compensation. Restricted stock units (RSUs) that are not "stocked out" immediately after vesting generally will be subject to Section 409A (since these become deferred units that are earned and vested). Other elements of the definition are discussed below.

- **Stock Appreciation Rights (SARs) and Stock Options.** Notice 2005-1 provides that SARs settled in stock of the company fall outside the definition of deferred compensation if (1) the stock is traded on an established market and (2) the exercise price is never less than the fair market value of the stock on the date of grant. Thus, cash-settled SARs, discounted SARs, SARs that have some post-exercise deferral feature, and all private-company SARs are subject to Section 409A. This means that these types of awards need to have a fixed payment date to be Section 409A compliant. Public or private company cash-settled or stock-settled SARs granted under a plan in effect prior to October 4, 2004 may be exempt from Section 409A. Stock options with an exercise price that is never less than the fair market value of the stock on the date of grant and which do not have a post-exercise deferral feature will not be subject to Section 409A. Accordingly, this could negatively impact the use of indexed options, which practitioners thought might become more popular following adoption of revised FAS 123 (since variable accounting no longer applies to indexed options), unless the arrangement similarly has a fixed payment date.

(continued on next page)

Steven R. Berger ■ Sara Stewart Champion ■ Thomas P. Desmond ■ Megan E. Meyers ■ Philip L. Mowery
Michael A. Nemeroff ■ Stewart Reifler ■ Robert F. Simon ■ Kelly A. Starr ■ Robert J. Stucker ■ William F. Walsh

- **2004 Bonuses Payable in 2005.** Generally, bonuses (both annual and long-term) paid in accordance with the "2-1/2 month rule" (i.e. – generally by March 15th for calendar year taxpayers) fall outside the definition of deferred compensation. Thus, a calendar year 2004 bonus paid by March 15, 2005 should be exempt from Section 409A. The deferral of a 2004 bonus on or before March 15, 2005 may – in certain instances – be valid not only with respect to Section 409A, but also with respect to the generally applicable constructive receipt rules.

- **Substantial Risk of Forfeiture.** Notice 2005-1 defines "substantial risk of forfeiture" as when the right to the compensation is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation. Also, the possibility of forfeiture must be substantial. A condition related to a purpose of the compensation must relate to the employee/service provider's performance for the employer/service recipient or the employer/service recipient's business activities or organizational goals (e.g. – the attainment of a prescribed level of earnings, equity value or a liquidity event). Any change in the vesting conditions after the beginning of the service period (e.g. – additional risk) will be ignored for purposes of Section 409A (thus eliminating the use of "rolling risk of forfeiture"). Also, noncompetition restrictions will not qualify as a substantial risk of forfeiture (although such restrictions still qualify as a substantial risk of forfeiture for purposes of Section 83 property transfers or Section 457(f) plans). Notice 2005-1 does provide that where an employee/service provider can elect to receive a materially greater bonus amount in a future year rather than a materially lesser bonus amount in an earlier year, the materially greater bonus may be considered to be subject to a substantial risk of forfeiture.

- **Change in Control.** Notice 2005-1 provides that a plan may permit a payment of deferred compensation upon the occurrence of certain "Change in Control Events." Generally, these are: (1) acquisition by a person or group of more than 50% of voting stock, (2) acquisition by a person or group of 35% or more of voting stock within a 12-month period, (3) replacement of a majority of directors during a 12-month period, or (4) acquisition by a person or group of 40% or more of assets (measured as total gross fair market value). While similar in structure to the Section 280G golden parachute definitions of change in control, the Section 409A definitions are more restrictive. Thus, there could be a change in control for Section 280G purposes (resulting in imposition of Section 4999 excise tax on amounts treated as "excess parachute payments") but not under Section 409A (resulting in no acceleration of payment of deferred compensation but also no treatment as excess parachute payments). Also, a "specified employee" (generally a public company employee having annual compensation greater than $130,000) apparently could receive payment on the date of the change in control if there is a Section 409A change in control, but if there is no change in control for Section 409A purposes, then the specified employee would still have to wait the requisite 6 months after a termination of employment to receive any payment.

- **Reporting of Deferred Compensation to the IRS.** Notice 2005-1 does not provide much guidance on the new reporting rules, but employers need to be aware that deferred compensation will soon be reported on both Form W-2 and Form 1099. Notice 2005-1 does provide a de minimis exception of $600.

- **Acceleration of Payments.** Notice 2005-1 provides very limited exceptions to the "no acceleration of payments" rule. These are: (1) pursuant to a domestic relations order, (2) to satisfy certain conflicts of interest restrictions, (3) payment of employment taxes (i.e. – FICA), (4) de minimis amounts (generally $10,000 or less), and (5) to pay income taxes under a Section 457(f) plan.

- **Deferred Compensation is Wages and Subject to Withholding.** Employers should note that deferred compensation falls into the definition of "wages" for withholding purposes. Notice 2005-1 states that additional guidance on withholding will be forthcoming.

- **Severance Plans.** Notice 2005-1 exempts certain severance plans from Section 409A during calendar year 2005, but not those that cover executives. Since the notice does not address whether and what kind of severance plans will be affected by Section 409A, further guidance will be necessary.

Notice 2005-1 provides important – but limited – guidance with respect to the new deferred compensation rules. But this is only the tip of the iceberg. Further guidance will be released in 2005 and perhaps in later years. In the meantime, companies and other organizations and their executives will need to follow this guidance when structuring and administering their 2005 nonqualified deferred compensation arrangements.