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RE: **IRS Notice 2005-1 Interpreting Code §409A**

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The American Jobs Creation Act of 2004 rewrote the tax rules applicable to non-qualified deferred compensation. In addition to the basic tax principles that previously governed non-qualified deferred compensation (e.g., constructive receipt), amounts deferred on or after January 1, 2005 – and in some cases even earlier deferrals – must now also satisfy new Code §409A. Among other things, §409A sets new standards for deferral elections, new constraints on subsequent elections regarding the time and form of payment, and a new ban on payment acceleration.

In our memorandum dated October 12, 2004, we summarized the statutory requirements under §409A that non-qualified deferrals will have to meet in order to avoid premature taxation and the new 20% penalty tax. In this memorandum, we focus on Notice 2005-1, issued December 20, 2004, which gives the first IRS guidance on these rules. This memorandum assumes some familiarity with the fundamental principles of §409A. To get a copy of our prior memo, please call or send your request by e-mail to DKelly@KHBlaw.com.

The following summarizes the answers that Notice 2005-1 has given to some of the most frequently asked questions about Code §409A and also points out some of the lingering areas of uncertainty. Additional guidance is expected and the rules are still being developed, so employers should proceed cautiously. There are some unique, limited-time opportunities offered by the guidance, however (one of which expires March 15, 2005), so employers who have not yet mapped out their compliance strategy will want to do so as soon as possible.

1. What types of compensation are affected by §409A? The new law applies to "deferred compensation", which the Notice defines as compensation to which a service provider (e.g. employee, outside director, independent contractor, etc.) has a legally binding right during one taxable year, but which is payable in a later year. For example, salary an employee earns in 2005, but elects to receive in 2008, is deferred compensation. Similarly, board fees an outside director earns in 2007 which are payable after she leaves the board in 2011 are deferred compensation because of the payment delay. However, there are some exceptions:

- Amounts payable under a pension, 401(k), 403(b) or other qualified plan are not subject to §409A.

- Benefits payable under certain welfare plans, such as a medical, LTD, or vacation pay plan, are not subject to §409A.

- §409A does not apply to amounts deferred under a Code §457(b) plan established by a tax-exempt or government employer. (However, it does apply to §457(f) plans.)

- Amounts earned in one year and paid during the first 2½ months of the following year are not deferred compensation. For example, the typical annual bonus plan under which the bonus is paid shortly after year-end would not be deferred compensation, but if the participant can elect a further deferral the exception may be lost. If the employer and employee have different tax years, the relevant year will be whichever ends later.

- Compensation is not considered earned (and, therefore, is not deferred compensation) during any period while the employer has the unilateral right to reduce or eliminate it (unless circumstances indicate that the discretion is unlikely to be exercised or reduction is contingent on an event that is unlikely to occur). For example, a long-term discretionary bonus under a program that gives the employer authority to set the bonus amount at zero would not be considered earned until the amount became fixed, and would not be deferred compensation unless payment was delayed for more than a short period after the date the amount was determined.

- Certain types of stock-based compensation are also exempt from the new rules. See Section 2.

- Deferred compensation earned and vested prior to 2005 is not subject to the new rules provided the terms are not materially modified after October 3, 2004. See Section 3.

2. How do the new rules apply to stock options, stock appreciation rights, and other equity-based compensation?

The Notice says that stock options, stock appreciation rights, and other equity-based compensation are subject to the new rules unless certain requirements are met.

For stock options, the requirements are quite simple: to be exempt from §409A, the exercise price of the option must be not less than the fair market value of the stock on the date the option is granted (i.e. no discounted options), and the option must not include the opportunity to defer receipt of the exercise proceeds. Any reasonable valuation method may be used to determine fair market value at grant.

Stock appreciation rights (SARs) on publicly traded stock also are exempt from §409A provided they meet requirements similar to those applicable to stock options – the amount payable upon exercise must not be greater than the amount by which the stock's value on the exercise date exceeds the stock's value on the SAR grant date, there must be no opportunity to defer the exercise proceeds, and payment must be made in stock. This exemption does not apply to SARs based on stock that is not publicly traded. Pending further guidance, however, an interim rule will, at least temporarily, allow SARs on the stock of privately-held companies and

cash settlements of any SARs, but in both cases only if the SARs are granted under a program that was in existence on October 3, 2004, and the amount payable and nondeferral requirements are met.

It will be important to structure options and SARs so that they qualify for the above exemptions because the typical terms allowing a grantee to exercise whenever he wants to will violate the election rules under §409A. (Another possible design available for options or SARs which do not qualify for the §409A exemption would be to require a fixed payment date at the end of the term. For example, a private company SAR could be issued to an executive January 1, 2006, with payment scheduled for January 1, 2011. In the meantime, she would be free to "exercise" the SAR by converting the SAR to a fixed deferred compensation account, but would not be permitted to actually receive the proceeds until the January 1, 2011 expiration date. This arrangement would be subject to §409A, but the fixed payment date would automatically meet the requirements.)

Restricted stock is not subject to the new rules unless the restricted stock gives the participant an opportunity to defer receipt of the proceeds after the restrictions lapse (e.g. by surrendering the restricted shares in exchange for a contractual right to receive payment later).

Restricted stock units that give a participant the contractual right to receive shares later (i.e. shares are not transferred until end of grant period) are deferred compensation subject to §409A.

3. Under what circumstances is compensation deferred before 2005 exempt from the new requirements?

In general, the new rules do not apply to deferred compensation that was "earned and vested" before 2005. Notice 2005-1 gives these guidelines for determining amounts that qualify for this exemption:

- For plans that base a participant's benefit solely on the balance of an account that earns interest or other earnings, the amount exempt from the new law would be the December 31, 2004 account balance (to the extent vested on that date), adjusted for subsequent earnings.

- For a non-account balance plan such as a supplemental executive defined benefit plan where the benefit is a percentage of final average earnings, the exempt amount is the actuarial equivalent present value of the amount that would have been payable if the participant had voluntarily terminated employment on December 31, 2004. (Benefit increases due to subsequent pay hikes and early retirement subsidies not yet earned would not be counted.)

- For equity-based deferred compensation, the exempt amount is the amount vested on December 31, 2004, adjusted for any subsequent changes in the value of the underlying equity securities.

- To qualify for the exemption for pre-2005 deferred compensation, the Plan must not be "materially modified" after October 3, 2004. The Plan can be operated in accordance with its pre-2005 terms. For example, if the Plan allowed in-service withdrawals subject to a haircut provision, such withdrawals can be permitted in the future. However, adding new withdrawal features or making other changes that make the Plan more flexible than it was before October 3, 2004 would be a "material modification" subjecting the pre-2005 deferred compensation to the new rules. Taking away features that existed in the past is not a material modification – for example, eliminating a haircut withdrawal provision would not be considered a material modification.

An employer does not have to run its plan in a way that qualifies for the exemption for deferred compensation earned and vested before 2005. Subject to any limiting contractual obligations, employers may change their plans so that the entire benefit (both pre-2005 and post-2004) complies with §409A. However, many employers will want to qualify for the pre-2005 exemption because it allows them to preserve plan terms that are not permitted with regard to post-2004 deferrals. For example, if a pre-2005 plan gives employees more flexibility over payout timing than would be permitted under §409A, the exemption would allow the employer to preserve the old payout terms on amounts deferred before 2005.

Employers who do consider changes that will bring their plan under the new rules should be aware of a potential trap for the unwary. The Notice states that plans adopted prior to December 31, 2005 must operate in good faith compliance with the new rules throughout 2005 with respect to benefits that are subject to the new rules. If an old benefit feature like a "haircut" provision that is no longer permitted under Code §409A was actually used in 2005, even if that occurred before action was taken to apply the new rules, the affected participant's benefit may fail good faith compliance. While it may be possible to fix this problem before the end of 2005 using the Notice's distribution or partial plan termination transition rules, it may be better to simply delay any actions in 2005 that might be inconsistent with the new rules.

Note that amounts which were not yet vested as of December 31, 2004, do not qualify for the exemption for pre-2005 deferrals.

4. What elections can be made in 2005 with regard to deferral of 2005 compensation?

Uncertainty about the new law led some employers and employees to hold off on making deferral elections regarding compensation payable in 2005. In such cases (and in any other case where an employer wants to permit new deferral elections on compensation for services earned or payable in 2005), Notice 2005-1 gives a one-time opportunity to make deferral elections by March 15, 2005, provided the following requirements are met:

- The election must be made before the scheduled payment date for the compensation. For example, if the deferral election relates to a bonus otherwise payable on March 1, 2005, the election would have to be made not later than February 28th. Note that this deadline is flexible enough so that the special rule

could be used to make a deferral election on a bonus earned in 2004 that is not yet payable.

- The election must relate all or in part to service performed on or before December 31, 2005. An election to defer a bonus earned in 2004 and payable March 15, 2005 would meet this requirement. So would an election to defer a long-term bonus earned for 2003-2007 because at least part of the service was before the end of 2005.

- The plan under which the election is made must be in existence on or before December 31, 2004. For example, if an employee wants to use this rule to defer 2005 salary, the employer must have had a deferred compensation plan in place during 2004 that permitted salary deferrals. The employer would not be free to create a new deferred compensation plan in 2005 in order to take advantage of the March 15 deferral rule; the plan would need to have been adopted on or before December 31, 2004.

- The plan must be amended before the end of 2005 to permit the elections that are being allowed on or before the March 15, 2005 deadline. We expect this requirement could be met by describing the March 15 election procedures in the amended Plan document which will need to be finalized by year end.

- The plan under which the deferrals are made must operate in accordance with §409A and be amended in 2005 to comply with all of the 409A requirements.

The IRS Notice says that operating under the foregoing procedures will not be treated as violating the usual constructive receipt rules. This is important because normally a deferral election made on a bonus that has been fully earned and is due to become payable a few days later would raise serious constructive receipt questions. The IRS is giving a free pass so long as the election is made by March 15, 2005 and meets the above requirements.

Note also that the rule described above gives a good way for employees to make elections now to defer receipt of amounts which are not yet vested and will not be paid until after 2005. For example, if an individual holds restricted stock units granted in 2004 that will not vest until 2008, the above election rules would give a way to elect deferral of the proceeds, even though §409A normally would say it is too late to elect such deferrals.

5. May an individual cancel an existing deferral election and receive a cash payment during 2005 of amounts deferred in 2005 or previously?

Notice 2005-1 gives employers a great deal of flexibility to cancel existing deferred compensation arrangements and distribute the proceeds in 2005. For example:

- An employer is permitted to terminate a deferred compensation plan, pay out the proceeds by the end of 2005, and not worry about complying with the new law. Obviously, there may be human resources and contractual issues if the employer unilaterally decides to accelerate payment of amounts which the employees do not

expect to receive until later, but at least in the eyes of the IRS, such a Plan termination is permitted and does not raise any troublesome issues under §409A.

- Employees can be permitted individually to elect to withdraw all or part of their deferred compensation balances by the end of 2005. Making the withdrawals elective should solve the HR and contractual issues noted in the preceding paragraph. Unfortunately, it does give rise to one tax ramification: if the employer allows employees to elect whether to withdraw their deferred compensation account balances during 2005, balances which are not withdrawn will be subject to the new §409A requirements and will not be eligible for the pre-2005 grandfather rules described in Section 3 above. That's because the election opportunity is considered a material modification triggering application of §409A.

6. When is a bonus "performance-based" so that it qualifies for a special deferral election deadline?

In general, Code §409A requires deferral elections to be made before the earliest year in which any portion of the compensation is earned. For example, a deferral election on pay that will be earned in 2006 must be made by December 31, 2005. (The March 15, 2005 deferral opportunity described in section 4 above is an exception to this rule.) However, there is a special exception to this rule for compensation that is "performance-based"; deferral elections on such compensation must be made at least 6 months before the end of the period during which the bonus is earned. For example, if a bonus is awarded for 2006 that qualifies as performance-based, the deadline for deferral elections on that bonus is June 30, 2006, rather than the usual December 31, 2005 election deadline. Notice 2005-1 declines to define "performance-based compensation", leaving that to later guidance, but it does establish an interim rule for bonus compensation that allows elections to be made under the same special timing rule (i.e., the election can be made as late as 6 months prior to the end of the service period) so long as that bonus compensation meets the following requirements:

- The bonus is based on services performed over a period of at least 12 months;

- The bonus must be contingent "on the satisfaction of organizational or individual performance criteria"; and

- At the time the deferral election is made, "the performance criteria are not substantially certain to be met".

Notice 2005-1 explicitly permits the use of subjective performance criteria, provided that the determination of whether these criteria are met is not made by the service provider himself, or by a family member of the service provider. For example, in a family-owned business, if an employee's parent is involved in using subjective criteria to determine the employee's bonus amount, the bonus would not qualify as performance-based.

The foregoing criteria are an interim interpretation. The IRS intends to issue more guidance about this later.

7. When must plans be amended to satisfy the new requirements?

Plan amendments must be adopted by December 31, 2005. Those amendments will need to take into account all applicable IRS guidance (including Notice 2005-1 and guidance the IRS will be issuing later in 2005), so there is little benefit and some risk in rushing to amend. In the meantime, plans must operate in accordance with a good faith interpretation of the Code §409A.

Of course, to the extent deferrals remain subject to the old rules and are not subject to §409A, employers will want make sure they avoid any actions that "materially modify" the terms of the old plan. They will also want to find ways to clearly distinguish the amounts subject to the old rules from the amounts subject to §409A.

8. What is a "change in control" that can trigger accelerated payment of deferred compensation?

Deferred compensation plans typically provide for accelerated payment if the employer changes control. In the past, employers have been free to adopt their own definitions of the change in control events triggering such payment. Under §409A, the Treasury Department is assigned the responsibility of defining "change in control" for purposes of §409A. Notice 2005-1 prescribes a definition which is different than many definitions we have seen in the past. Employers will have to take the new definition into account because other definitions may lead to adverse tax treatment. Coordinating the new §409A definition with the definition the employer already uses will cause some knotty problems that will require attention during 2005. Other definitions that are in all respects more restrictive than the Notice 2005-1 definition should not cause problems. A plan need not provide for payment on all events described by the presribed definition. Use of a less restrictive definition, though, would violate §409A.

9. What reporting requirements apply to deferred compensation?

Notice 2005-1 outlines the W-2 and 1099 reporting requirements applicable to deferred compensation, beginning with these forms for the 2005 tax year (i.e., the forms distributed in January, 2006). Let us know if you want more information about that subject at the present time.

10. How does §409A apply to severance pay plans?

Severance pay plans typically allow a choice between paying benefits as a lump sum or in installments on regular scheduled pay dates. This may result in stretching payments into tax years after the employee is terminated. Notice 2005-1 does not resolve whether this is a problem under §409A. Presumably, this will be addressed in future guidance. However, 2005-1 does provide that in the meantime, a severance plan that either (i) is collectively bargained or (ii) covers no "key employees" (as defined in Code § 416(i) – for a large employer, the 50 highest paid officers earning at least $130,000 per year) is not subject to §409A for 2005. For other severance plans, if §409A is a problem, we anticipate the solution will involve establishing fixed payment terms (e.g. always pay a lump sum, or always pay in installments) by the end of 2005.

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As noted earlier, Notice 2005-1 is the initial IRS guidance interpreting Code §409A. There will be additional guidance during 2005. We will keep you posted.

In the meantime, let us know if you have questions about the above or about other §409A issues.