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**Re: Year-End Actions to Comply With Code §409A**

Dear Clients and Other Friends:

While the proposed regulations under Code §409A extend most of the generous transition rules of Notice 2005-1 to the end of 2006, some of those transition rules still require action by December 31, 2005. This installment in our series of letters on the proposed regulations identifies actions that may need to be taken in 2005, either to satisfy a transition rule requirement or to take advantage of a transition opportunity that has not been extended into 2006.

**Summary: While plan amendments to comply with §409A generally do not have to be adopted until next year, many employers will need to adopt relatively simple amendments by December 31, 2005, documenting how they handled certain §409A transition issues during 2005. In addition, some of the §409A transition rules expire at the end of 2005, and employers that want to use those rules need to act quickly. This letter provides an overview of these year-end issues.**

**I. Adopt Amendments For Deferrals That Used The March 15<sup>th</sup> Rule**

Notice 2005-1, Q&A-21 created a limited exception to the usual §409A deferral election timing rules and allowed plans to give participants until March 15, 2005, to elect to defer compensation for services performed all or in part before the end of 2005 (including compensation already earned but not paid – a substantial departure from the government's traditional tax position). That opportunity was made subject to a variety of conditions, however, including a requirement that the election be made in accordance with the terms of the plan in effect on or before December 31, 2005.

The proposed regulations generally extend the requirement that plan documents be amended to conform to Code §409A until the end of 2006. Because Q&A-21 – which created the March 15<sup>th</sup> deferral opportunity – explicitly refers to that amendment rule, one might think an amendment to use the March 15<sup>th</sup> rule could wait until the end of 2006 and be adopted retroactively. In their public appearances, however, IRS and Treasury Department representatives have repeatedly indicated that the general extension of the plan amendment opportunity to 2006 does **not** apply to the requirement that a plan's terms include authorization for elections under the March 15<sup>th</sup> rule of Q&A-21 by the end of 2005. As a result, if the terms of a plan did not authorize elections made under the transition rule for elections by March 15<sup>th</sup>, an amendment will be needed by the end of 2005.

Plan documents drafted prior to §409A were sometimes vague about the timing of deferral elections. It is possible that the written terms of such a plan (e.g., due to such vagueness or possibly because the plan only authorized annual bonus compensation) could be taken as already authorizing elections made under the March 15<sup>th</sup> rule and that no plan amendment is necessary. Most plans that used the March 15<sup>th</sup> rule, however, probably did not clearly authorize those elections and thus should be amended by the end of this year.

## **II. Cancellation of 2005 Deferrals and Other Full or Partial Plan Terminations**

Notice 2005-1, Q&A-20(a) allows plans to be amended before December 31, 2005, to permit participants to terminate their participation in a plan, or to cancel a deferral election. Termination or cancellation could be done in whole or in part, and plans could, instead of giving participants the choice, impose a full or partial termination of deferrals. This relief was **not** extended by the proposed regulations, so any such terminations or cancellations must occur in 2005.

If this transition relief is used, terminated or cancelled deferrals are not treated as causing the relevant plan to violate §409A, no matter how flawed the deferrals.

Some plan sponsors decided to take advantage of cancellation relief by giving participants the opportunity to revoke their 2005 deferral elections. Sponsors who took that approach presumably have already begun the process of soliciting deferral revocations. In addition to the actual revocation election process, however, it is apparently also necessary to document the authority to allow such revocations, and any other terminations or cancellations, by the end of 2005. This documentation deadline also is not readily apparent given the general extension of the amendment deadline granted by the proposed regulations, but it is nevertheless apparently the government's position that uses of the cancellation/termination rule must be documented by December 31, 2005.

Written action by the end of 2005 is also apparently required if a sponsor has used or intends to use the relief in Notice 2005-1, Q&A-18(c) to completely terminate an arrangement and distribute all of the deferred compensation thereunder. Few plans, though, appear to have used that rule.

## **III. Amend Plans to Characterize 2005 Distributions as Terminations of Deferrals**

Another use of the transition rule in Notice 2005-1, Q&A-20 is to fix §409A problems created by amounts that were distributed in 2005 (and therefore can no longer be fixed any other way). If those amounts are recharacterized as partial terminations under Q&A-20, then their noncompliance should not affect the §409A compliance of other amounts deferred under the same plan. The remaining deferred amounts can then be fixed to comply with §409A without concern that amounts distributed in 2005 will trigger penalties on all deferrals under the plan.

Recharacterization may have several applications, for example:

- Haircut distributions;
- Nonconforming hardship distributions;
- Exercises of nonexempt options and SARs;

- Distributions due to nonconforming disabilities;
- Distributions triggered by events that fail the §409A fixed payment date requirement;
- Distributions upon a change in control that does not satisfy the §409A definition, and
- Distributions made within six months after a public company key employee's termination of employment.

By recharacterizing these events as partial terminations, the amounts distributed can be disregarded for §409A compliance purposes and will not taint other, compliant, deferrals.

Like revocations of 2005 deferral elections, these uses of the cancellation/termination rule in Q&A-20 must be documented by December 31, 2005. In these cases, the plan document may already clearly authorize the action that triggered the distribution – for example, exercise of a nonexempt stock option – but the plan will not likely have characterized that action as a termination or cancellation of a deferral. In order to secure the intended characterization of events, then, it may be prudent to adopt a simple amendment to the plan before the end of 2005 explicitly characterizing distributions of noncompliant deferrals as terminations or cancellations under Q&A-20 of 2005.

#### **IV. Participant Elections With Respect to 2006 Payments**

Notice 2005-1, Q&A-19(c) opened a sweeping transition exemption allowing participants to make new payment elections with respect to amounts already deferred, provided the elections were made by December 31, 2005 and the plan was amended by that date to authorize the special elections.<sup>1</sup>

The proposed regulations extend the opportunity to make new elections until the end of 2006, but impose some limitations. In particular, they bar any election in 2006 to delay the distribution of amounts otherwise payable in 2006, as well as any election in 2006 to accelerate payments into 2006.

Read together, these rules suggest a limited time opportunity. While the proposed regulations expressly limit elections made *in 2006*, it appears that they do not limit the ability under Notice 2005-1 to make a new payment election *in 2005* to either (i) delay the payment of amounts otherwise payable in 2006, or (ii) accelerate into 2006 the payment of amounts that would otherwise be payable in later years, provided such an election can be defended under other applicable tax law principles, principally among them the doctrine of constructive receipt. If either of these elections are desired, action would have to be taken by the end of 2005. To the extent such elections would be made primarily under Notice 2005-1 rather than the proposed regulations, it would be prudent to assume that both the elections and an amendment authorizing the elections, should be made by December 31, 2005, unless the plan would already clearly permit such an election.

<sup>1</sup> This opportunity to make new payment elections applies only to amounts subject to §409A. Amounts that are treated as deferred before 2005 because they were earned and vested prior to 2005 and not modified after October 3, 2004, are grandfathered and not subject to §409A.

## **V. Non-Exempt Stock Options and Stock Appreciation Rights**

As we noted in our earlier letter on stock rights (the proposed regulations' collective term for stock options and stock appreciation rights or "SARs"), most options and SARs will not be subject to §409A because they will not constitute deferred compensation. Stock rights avoid characterization as deferred compensation if: (i) the exercise price can never be less than the fair market value of the underlying stock on the date of grant; (ii) the option does not include any feature for the deferral of compensation other than deferral until the exercise or disposition of the option or vesting of the stock received upon exercise; and (iii) the option is on common stock of the service recipient.

If options or SARs do not meet these requirements (for example, because they have a discount exercise price or because their terms have been extended, causing them to be treated as having a deferral feature), they are subject to §409A unless they are treated as amounts deferred before 2005 because they were earned and vested prior to 2005 and not modified after October 3, 2004. If they do not qualify as amounts deferred prior to 2005, such stock rights will almost certainly trigger a violation after 2005 because they are generally exercisable at the discretion of the service provider and not at a fixed time specified or elected in accordance with §409A.

Plans that have granted such non-exempt options or SARs should consider taking the following steps in connection with noncompliant stock rights:

- Notifying holders of non-exempt options and stock appreciation rights as soon as possible that (i) the free exercise of their stock rights in 2006 may violate §409A, (ii) if their stock rights are currently exercisable, exercise in 2005 will eliminate the §409A violation problem (because the exercise can then be treated as a termination of their noncompliant stock rights under the transition relief in Q&A-20), and (iii) if they do not exercise in 2005, their ability to choose when their rights are exercised may be greatly constrained.
- If non-exempt stock rights remain after 2005, imposing a temporary hold on the exercise of those rights in order to allow time to educate the holders about the potential adverse §409A consequences of exercises in 2006, and to give the plan sponsor time to determine and carry out a strategy for fixing those stock rights or replacing them in a way that will avoid §409A violations. Such a strategy could include setting a fixed exercise date, allowing holders to elect in 2006 a future fixed exercise date after 2006, or replacing old rights.
- Substituting stock rights that are not deferred compensation (and therefore are not subject to §409A) for the non-exempt rights. This strategy seems most applicable to the elimination of discount options, but it may, if coupled with other steps, provide a mechanism for solving problems with other kinds of noncompliant stock rights.

The foregoing is not an exclusive list. The application of §409A to stock-based incentive plans, especially omnibus stock plans that include restricted stock units, performance awards and possibly other forms of compensation in addition to options and SARs can get complicated and may require other actions.

## **VI. Good Faith Compliance**

Speakers from IRS and Treasury have repeatedly offered assurance that the rules were not intended to create traps, and that the transition rules have been made unusually flexible with the intent of easing the transition. The failure to extend all of the plan documentation requirements, however, does seem to create unnecessary confusion about what must be done by the end of 2005. For many plans, continued good faith compliance with the new rules in operation will be sufficient. For some, however, action will need to be taken in the next few weeks, even if such action amounts to nothing more than a simple amendment designed to conform the terms of the plan as in effect on December 31, 2005, to certain actions taken in good faith compliance with the transition rules.

If you have questions regarding any of the transition rules, or think you may need a transition amendment and would like our help in drafting that amendment, please let us know.

Sincerely,

John W. Haine

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