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IRS Issues Notice 2005-1 Clarifying Certain Provisions of New Tax Law Affecting Nonqualified Deferred Compensation Plans

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On December 20, 2004, the Treasury Department and Internal Revenue Service issued Notice 2005-1 (the "Notice"), which explains certain aspects of Section 409A of the Internal Revenue Code of 1986 (the "Code"), as recently amended by the American Jobs Creation Act of 2004. The Notice indicates that it is the first in what is expected to be a series of guidance with respect to the application of Section 409A, and is not comprehensive. The Notice requests comments on all aspects of the application of Section 409A and it is not expected that additional formal guidance will be issued until after those comments have been received and considered, which most likely will not occur until mid-2005.

Highlights

Some important highlights of the information provided in the Notice are:

- Plans have until December 31, 2005 within which to be retroactively amended to comply with the new Section 409A requirements.
- In the interim, plans subject to Section 409A must be operated in good faith compliance with the language of Section 409A and the information provided in the Notice and based upon a reasonable interpretation of any issues not addressed by the Notice.
- Participants generally have until March 15, 2005 within which to make deferral elections with respect to 2005 compensation that has not become payable at the time the election is made.
- Amounts distributed within 2½ months after the end of either the employee's or the employer's taxable year in which the compensation ceases to be subject to a substantial risk of forfeiture are not subject to Section 409A.
- SAR's settled with stock of a publicly traded employer, and until further guidance, SAR's issued under plans in effect before October 3, 2004, and meeting certain other requirements, are exempt.
- Restricted stock and other restricted property that is taxable pursuant to Section 83 generally is exempt, but deferred stock and other rights to receive property in a future year may be subject to Section 409A.
- Distributions made on account of a Change in Control Event, as defined in the Notice, are permissible.
- Distributions for certain specified purposes (e.g., to fulfill a domestic relations order, to pay taxes on benefits under a Section 457(f) plan, or to make de minimus distributions) do not violate Section 409A's prohibition on benefit accelerations.
- Plans may be terminated on or before December 31, 2005, and benefits distributed, if certain conditions are met.
- Plans may permit participants to elect, on or before December 31, 2005, to terminate their participation and receive distribution of their benefits, or to cancel their deferral elections, if certain conditions are met.

> *"Plans that are subject to Section 409A must be operated in good faith compliance with the new rules beginning January 1, 2005."*

- Severance pay plans that do not cover key employees or that are collectively bargained are not subject to Section 409A for 2005. Severance pay plans that cover key employees may be subject to Section 409A if they do not require lump sum payments shortly after severance.

Since plans that are subject to Section 409A must be operated in good faith compliance with the new rules beginning January 1, 2005, employers should identify as soon as possible the plans they maintain that are subject to Section 409A, and immediately begin to administer those plans in accordance with Section 409A and the Notice. The following is a brief overview of Section 409A (for a more complete summary, see our October 2004 Alert regarding Section 409A) and a more detailed summary of the more significant aspects of the Notice, that employers will need to take into account in connection with that review.

Overview of Section 409A

> *"Employers should identify as soon as possible the plans they maintain that are subject to Section 409A, and immediately begin to administer those plans in accordance with Section 409A and the Notice."*

Section 409A generally is effective with respect to amounts deferred under a nonqualified deferred compensation plan on or after January 1, 2005. As discussed in greater detail in our October 2004 Alert, Section 409A imposes certain new requirements on nonqualified deferred compensation plans, including rules regarding when elections to defer compensation must be made, when elections must be made to choose the form of distributions (lump sum, installment, etc.), the times when distributions may be made and prohibitions against the acceleration of the timing of benefit distributions. If a plan fails to satisfy those new requirements, then those participants with respect to whom the new requirements are not met are immediately taxable on their vested benefits to the extent those benefits cease to be subject to a "substantial risk of forfeiture" as that term is used in Section 409A. The tax on those benefits is subject to interest at a rate equal to 1% above the rate applicable to tax underpayments (which interest accrues from the date on which the deferral was made), and the taxable amount is subject to a 20% additional tax. Section 409A also provides that transfers of assets to offshore trusts or based upon an employer's financial health will cause benefits to become immediately taxable and subject to the foregoing interest and 20 % additional tax.

The Act requires that guidance be issued within 60 days of enactment to provide certain transitional rules for these new requirements. Section 409A also provides that one of the potential events that could trigger a distribution under a nonqualified deferred compensation plan is a change in control, to the extent permitted by regulations, and requires that guidance be issued within 90 days of the date of enactment to explain what constitutes a change in ownership or control for purposes of these new rules.

What is Considered a Nonqualified Deferred Compensation Plan?

- **General Rule.** Section 409A defines a nonqualified deferred compensation plan simply to mean any plan (other than certain qualified plans and welfare benefit plans) that provides for a deferral of compensation by a "service provider" (referred to in this Alert as the "employee"). The Notice states that a plan will be considered to provide for the deferral of compensation for these purposes only if, under the terms of the plan and the relevant facts and circumstances, an employee or other service provider has a "legally binding right" to the compensation that is payable in a later year. For these purposes, a "legally binding right" will not be deemed to exist if the compensation may be unilaterally reduced or eliminated by the entity for which the services are provided (referred to

"A plan will be considered to provide for a deferral of compensation…only if…an employee or other service provider has a 'legally binding right' to compensation that is payable in a later year."

"Until additional guidance is issued, a deferral of compensation will not be deemed to have occurred if payment is…made within 2 1/2 months after the end of [either the employee's or the employer's] taxable year in which the compensation is no longer subject to a substantial risk of forfeiture."

in the Notice as the "service recipient" and in this Alert, simply as the "employer") after the services for which the compensation is being paid have been performed. Compensation will not be considered to be subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the failure to satisfy an objective substantial risk or forfeiture other than the performance of services for which the compensation is being paid.

Under the foregoing general approach in the Notice, a plan that provides for vesting based upon completion of years of service, and for payment of compensation as and when (and in the same taxable years as) the services are completed, would not appear to constitute a nonqualified deferred compensation plan, and thus would not be subject to the requirements of Section 409A.

- **Temporary Exemption for Short Term Deferrals.** The Notice states that until additional guidance is issued, a deferral of compensation will not be deemed to have occurred (and hence Section 409A would be inapplicable) if payment is required to be made within 2½ months after the end of the employee's taxable year, or within 2½ months after the end of the employer's taxable year, in which the compensation is no longer subject to a substantial risk of forfeiture. It is important to note that this exception is based on the date on which the compensation is no longer subject to a substantial risk of forfeiture (which may include vesting conditions other than continued service), rather than when a "legally binding right" to the compensation is created, which generally is deemed to exist once the services upon which the compensation is based have been performed. Thus, for example severance pay and change in control benefits that are paid as lump sum payments within 2½ months after the end of the year in which the severance or change in control occurs should be exempt from Section 409A under this rule.

- **Equity Based Awards.** The Notice states that except as otherwise provided in the Notice, nonqualified stock options, stock appreciation rights and other equity based compensation are subject to Section 409A.

  - **Nonstatutory Stock Options.** The Notice provides that nonstatutory stock options are exempt from Section 409A if the exercise price for the option can never be less than the fair market value of the stock on the date of grant and the option does not provide a feature for the deferral of compensation after the exercise or disposition of the option. For these purposes, the Notice states that any reasonable valuation method may be used to determine the fair market value of the stock. Thus, by negative implication, discounted stock options generally will be treated as deferred compensation subject to Section 409A. The Notice points out that the right to receive substantially nonvested stock upon exercise of a stock option (an approach commonly used to help optionees minimize their tax liability), does not constitute a feature for the deferral of compensation. The Notice provides that if options are granted in tandem with other awards, such as stock appreciation rights, that are treated as deferred compensation, then the entire arrangement will be deemed to provide for the deferral of compensation. Under the Notice the substitution of a new option for an outstanding option, or the assumption of an outstanding option, by a different compa-

ny pursuant to a corporate transaction, will not be treated as the grant of a new option or a change in the form of payment for purposes of Section 409A if the ratio of the option price to the fair market value of the shares subject to the option immediately after the substitution or assumption is not greater than the ratio of the option price to the fair market value of the shares subject to the option immediately before the substitution or assumption.

"A payment of stock or cash pursuant to exercise or cancellation of a stock appreciation right granted under an SAR plan in effect on or before October 3, 2004 will not be subject to the requirements of Section 409A [if certain requirements are met]."

- **Exemption for Statutory Stock Options.** The Notice confirms that incentive stock options described in Section 422 of the Code, and options granted under employee stock purchase plans described in Section 423 of the Code, do not result in a deferral of compensation under Section 409A. The Notice does not address whether discounted options granted under an employee stock purchase plan that would satisfy the requirements of Section 423 but for the fact that the options are granted to individuals who are not employees of the issuer or any "parent" or "subsidiary" corporation of the issuer, as those terms are strictly defined in Section 423, will be exempt from the provisions of Section 409A.

- **Stock Appreciation Rights or SARs.** The Notice states that stock appreciation rights generally are covered under Section 409A, but indicates that they may be structured to comply with the provisions of Section 409A. The Notice indicates that an SAR generally will satisfy the requirements of Section 409A if the plan provides a fixed date on which the SAR benefit is to be paid to the employee-participant. Thus, for example, the holder of an SAR can exercise the right at any time prior to termination of employment, and upon termination of employment receive payment in the amount by which the fair market value of the underlying stock when the SAR was exercised exceeded the grant price, plus earnings from the date of exercise through the date of termination measured on a basis provided under the plan.

- **Exemption for SARs Settled with Publicly Traded Stock.** Under the Notice, SARs will be exempt from Section 409A if (i) the grant price can never be less than the fair market value of the underlying stock on the date the right is granted, (ii) the stock subject to the right is traded on an established securities market, (iii) the right will be settled only by the delivery of such traded stock upon exercise, and (iv) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. Further, the receipt of substantially nonvested stock upon the exercise of the right will not constitute a feature for the deferral of compensation. It is anticipated that "stock settled SARs" will gain popularity as a result of changes in the financial accounting rules relating to options, and this exemption clears the way for their use without restriction by the requirements of Section 409A except for (i)-(iv) above.

- **Temporary Transitional Rule for Other SARs.** The Notice states that until further guidance is issued, a payment of stock or cash pursuant to the exercise or cancellation of a stock appreciation right granted under an SAR plan in effect on or before October 3, 2004 will not be subject to the requirements of Section 409A if: (i) the grant price

is not less than the fair market value of the underlying stock on the date the SAR was granted, and (ii) the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. This exception should provide at least temporary relief for many existing SAR programs. It is not clear, however, whether the exception will apply to SARs whose value is measured on the basis of appreciation of something other than fair market value, such as increases in net book value. Arguably, the exemption should apply to those arrangements as well, if the same method for determining value is used to determine both the grant price and the value upon exercise of the rights.

- Restricted Property. The Notice provides that the grant of restricted stock and other restricted property, which generally become taxable pursuant to Section 83 of the Code when the transferred stock or other property is transferable or no longer subject to a substantial risk of forfeiture (or is includable in income when received as a result of a valid, timely filed Section 83(b) election), does not result in a deferral of compensation under Section 409A. On the other hand, deferred stock arrangements pursuant to which a participant obtains a legally binding right to receive property in a subsequent year may be subject to Section 409A requirements.

What Service Providers are Subject to Section 409A?

The Notice states that until further guidance is issued, a service provider to whom Section 409A applies includes individuals, whether they are employees or independent contractors, and certain entities that provide personal services. Section 409A does not, however, apply to arrangements between taxpayers all of whom use the accrual method of accounting, nor to arrangements between a service provider and a service recipient if the service provider is actively engaged in the trade or business of providing substantial services, other than as a director of a corporation or as an employee, and provides such services to two or more unrelated service recipients. Thus, for example, Section 409A should not apply with respect to fees paid by a client to its accounting or law firm.

How Does Section 409A Apply to Arrangements Between a Partner and a Partnership?

The Notice indicates that until further guidance, taxpayers may treat the grant of equity interests in partnerships, and options to purchase partnership interests, in a manner consistent with the rules applicable to equity awards granted by corporations. The Notice also states that until further guidance, the issuance of a profits interest by a partnership for services generally will not be treated as resulting in a deferral of compensation, even though the service provider is not required to recognize immediate income as a result of the grant of such an interest. Payments, other than certain payments pursuant to a written retirement plan, payable in liquidation of the interest of a retiring or deceased partner, generally will not be subject to Section 409A, but those rules may apply to payments treated as guaranteed payments to a partner not acting in his capacity as a partner (i.e. payments for services that are determined without regard to partnership income).

What Plan Benefits Are Taxable If a Plan Fails to Satisfy Section 409A?

The Notice provides some relief with respect to the consequences of a plan's failure to satisfy the

requirements of Section 409A. In defining what constitutes a "plan" for this purpose, the Notice states that unless otherwise specified in the Notice, the requirements of Section 409A are applied as if a separate plan or plans is maintained for each employee. Also, all compensation deferred with respect to a particular employee under one or more account balance plans (i.e., plans in which benefits are equal to the value of the employee-participant's accounts under the plans) is treated as deferred under a single plan, all compensation deferred under one or more nonaccount balance plans (such as defined benefit arrangements or SERPs) is treated as deferred under a separate single plan, and all compensation deferred under one or more plans that are neither account balance plans nor nonaccount balance plans (such as discounted stock options, stock appreciation rights and other equity-based compensation) is treated as deferred under a separate single plan.

"Compensation will be deemed to be subject to a 'substantial risk of forfeiture' if it is conditioned on either the performance of substantial future services…or the occurrence of a condition related to a purpose of the compensation…and…is substantial."

As a result, if one type of plan is deemed not to comply with the requirements of Section 409A, the adverse consequences of such failure (immediate taxation, plus interest, plus a 20% additional tax) will apply only with respect to the one type of plan that has not complied and not the other type(s) of plans in which the employee is a participant. Further, violations of Section 409A with respect to the benefits of one employee will not create adverse tax consequences for the other employees whose benefits are in compliance, since a separate plan would be deemed to exist for each employee.

What is a Substantial Risk of Forfeiture?

- **General Rule.** The Notice states that for purposes of Section 409A, compensation will be deemed to be subject to a "substantial risk of forfeiture" if it is conditioned on either the performance of substantial future services (e.g., must remain continuously employed by the employer for the next 3 years) or the occurrence of a condition related to a purpose of the compensation (e.g., EBITDA goal must be achieved for a specific fiscal year), and if the possibility of forfeiture is "substantial." A condition related to a purpose of the compensation must relate to the employee's performance for the employer or the employer's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). The addition of substantial risks of forfeiture after the beginning of the service period, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, will be disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture for purposes of Section 409A. Thus, a rolling risk of forfeiture (i.e., one in which the initial vesting date is pushed back at the election of the employer or employee) will not qualify as a "substantial risk of forfeiture" for these purposes. The Notice further provides that an amount will not be considered to be subject to a substantial risk of forfeiture for these purposes merely because the right is conditioned upon the employee's satisfaction of a covenant not to compete. Also, salary and other vested compensation generally cannot be made subject to a substantial risk of forfeiture. The Notice indicates, however, that a bonus, for example, can be made subject to a substantial risk of forfeiture, if the bonus that will be payable if the risk of forfeiture is satisfied would be materially greater than the bonus the employee elected to forego.
- **When is a Risk of Forfeiture "Substantial"?** In determining whether compensation payable to an employee who owns a significant amount of the stock of the employer corporation or its par-

ent, is subject to a "substantial" risk of forfeiture, the Notice requires that there be taken into account (i) the employee's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the employee and the corporation and the extent to which the employee is subordinate to other employees, (iii) the employee's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the employee's discharge, and (v) past actions of the employer in enforcing the restrictions. The Notice indicates, by way of example, that if 4% of the voting power of the stock of a corporation is owned by the president and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on the right to deferred compensation of the president is not substantial, and, therefore, such rights are not subject to a substantial risk of forfeiture for purposes of Section 409A. This conclusion, (which also appears in Treasury Regulations which define the meaning of a substantial risk of forfeiture under Section 83) seems questionable, however, if for example, the right to enforce the risk of forfeiture is given to a compensation committee, which has a fiduciary obligation to act in the best interests of all shareholders.

Distributions on Account of a Change in Control

- **What is a Change in Control Event?** As indicated above, Section 409A provides that to the extent provided by regulations, a plan may permit deferred compensation to be distributed on account of a "change in ownership" or "change in effective control" of the corporation, or a "change in the ownership of a substantial portion of the assets" of the corporation. The Notice generally permits distributions upon the occurrence of any of those events (collectively referred to in the Notice as a "Change in Control Event"). To qualify as a Change in Control Event, the event must be determinable based on objective criteria, and any requirement that any other person, such as a plan administrator, board of directors, or compensation committee, certify the occurrence of the Change in Control Event must be strictly ministerial and not involve any discretionary authority. For this purpose, a payment will be treated as occurring upon a Change in Control Event if the right to the payment arises due to the corporation's exercise of discretion under the terms of the plan to terminate the plan and distribute the compensation deferred thereunder within 12 months of the Change in Control Event. This statement in the Notice is welcome news, since it clarifies that without violating Section 409A, an acquiring company may terminate a deferred compensation plan of a company it acquires if the plan so allows and the termination and distribution of benefits occurs within 12 months of the acquisition.

  - **What is a Change in Ownership?** The Notice generally provides that a "change in the ownership" of a corporation will be deemed to have occurred if any one person or more than one person acting as a group acquires stock of a corporation that constitutes more than 50% of the total fair market value or total voting power of the stock of the corporation. Stock acquired by any person or group of people who already owns more than 50% of such total fair market value or total voting power of stock will not trigger be a change in ownership.

  - **What is a Change in Effective Control?** A "change in the effective control" of a corporation generally will be deemed to have occurred if within a 12 month period either (i) any one person or more than one person acting as a group acquires ownership of stock possessing 35% or more of the total voting power of the stock of the corporation, or (ii) a majority of the members of the corporation's board of directors is replaced by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.
  - **What is a Change in Ownership of a Substantial Portion of Assets?** A "change in the ownership of a substantial portion of the corporation's assets" generally is deemed to occur if within a 12 month period any person, or more than one person acting as a group, acquires assets from the corporation that have a total gross fair market value at least equal to 40% of the total gross fair market value of all of the corporation's assets immediately prior to such acquisition. The gross fair market value of assets is determined without regard to any liabilities associated with those assets. Transfers of assets by a corporation to related entities whom they control or are controlled by do not constitute a change in the ownership of the assets for these purposes.

- **Which Corporation Must Have a Change in Control Event?** The Change in Control Event must relate to the corporation for whom the participant is performing services, the corporation that is liable for the payment of the deferred compensation, or a corporation that is a majority shareholder of one of those foregoing corporations, or is in a chain of corporations ending with one of the foregoing corporations, in which each corporation is a majority shareholder of another corporation in the chain. The attribution rules under Section 318(a) of the Code apply for purposes of determining stock ownership for this purpose.

Permissible Accelerations of the Timing of Distributions. The Notice provides that a plan will not be deemed to violate the Section 409A prohibition against acceleration of the time or schedule of any payment under the plan if the payment is on account of one of the following events:

- The waiver or acceleration of a condition constituting a substantial risk of forfeiture, provided that the other requirements under Section 409A relating to deferred compensation are satisfied.
- A distribution that is necessary to fulfill a "domestic relations order" as defined in Section 414(b)(1)(B) of the Code.
- A distribution necessary to comply with a "certificate of divestiture" as defined in Section 1043(b)(2) of the Code (relating to the divestiture by certain public officials of certain assets to avoid conflicts of interest).
- A distribution under a Section 457(f) plan to a participant to pay income tax withholding due upon a vesting event.
- A distribution by reason of an amendment to a plan that does not otherwise provide for de minimus cashout payments to permit the acceleration of the time or schedule of a payment, provided that the payment is of the entire amount of the participant's interest in the plan, is made either by December 31st of the calendar year in which the participant's separation from service occurs or within 2½ months after the partici-

pant's separation from service, and the payment is not greater than $10,000. A plan also may be amended with regard to future deferrals to provide that, if the value of a participant's interest under the plan is less than an amount specified in the plan at the time that amounts are payable under the plan (which amount does not appear to need to be limited to $10,000), then the participant's entire interest under the plan must be distributed as a lump sum payment.

- Payments to pay FICA taxes on compensation deferred under the plan or to pay income withholding taxes on such FICA payment.

Effective Date and Transition Rules

- General Rule for Grandfathered Benefits. Section 409A generally applies with respect to amounts deferred on or after January 1, 2005. The Notice states that for these purposes, an amount is considered deferred before January 1, 2005, and thus generally is exempt from the requirements of Section 409A, if the employee has a legally binding right to be paid the amount and the right to the amount is "earned and vested." The Notice states that a right is earned and vested only if the amount is not subject to a substantial risk of forfeiture within the meaning of Section 83 of the Code or to a requirement to perform further services. Thus, amounts deferred prior to January 1, 2005, but which become vested (under Section 83 concepts) on or after that date, will be subject to the Section 409A requirements.

- What Portion of Deferred Compensation is Grandfathered? The Notice also provides guidance as to the amount of compensation that will be deemed to have been deferred before January 1, 2005.

  - Nonaccount Balance Plans. In the case of a "nonaccount balance plan," such as a defined benefit SERP, the amount deferred before January 1, 2005 is equal to the present value as of December 31, 2004 of the amount to which the participant would be entitled under the plan if the participant voluntarily terminated services without cause on December 31, 2004 and received the full payment of plan benefits on the earliest possible date allowed under the plan following the termination of services, to the extent that right is both "earned and vested" as of December 31, 2004. The actuarial assumptions contained in the plan are to be used for these purposes as long as they are reasonable.

  - Account Balance Plans. In the case of an "account balance plan," which generally would include any deferred compensation plan in which the participant's benefits are measured based upon the value of the participant's account, the amount deferred before January 1, 2005 is equal to the portion of the participant's account balance as of December 31, 2004 that is earned and vested as of December 31, 2004, and any subsequent earnings thereon.

  - Equity Based Plans. In the case of equity based plans, amounts deferred before January 1, 2005 are determined on the same basis as the method used for account balance plans, except that the equity based amount is deemed to be the amount of the payment available to the participant on December 31, 2004 (or that would be available to the participant if the equity based right were immediately exercisable). Any appreciation (or depreciation) in the value of the underlying stock after December 31,

2004 (equity changes in awards deemed to have been deferred prior to January 1, 2005) is treated as earnings (or losses) on the amount deferred, and thus is not subject to the requirements of Section 409A.

Materially Modified Plans that Lose Grandfathering

"Amending an arrangement on or before December 31, 2005 to terminate the arrangement and distribute the amounts of deferred compensation thereunder will not be treated as a material modification."

- **General Rule.** Section 409A provides that earned and vested amounts deferred prior to January 1, 2005 will be deemed to have been deferred on or after January 1, 2005, and thus subject to Section 409A, if the plan is "materially modified" after October 3, 2004, unless the modification is pursuant to Treasury guidance. The Notice clarifies that for these purposes, a modification of a plan is considered to be a "material modification" if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added, and that this is true whether the modification occurs pursuant to a plan amendment or the employer's exercise of discretion under the terms of the plan. Thus, for example, a material modification would occur if an employer accelerated vesting of a benefit under the plan to a date on or before December 31, 2004. However, the exercise of discretion by an employer or an employee over the time and manner of payment of a benefit pursuant to discretionary authority provided to the employer or employee under the terms of the plan as they existed on October 3, 2004 would not be treated as a material modification. Changes to the notional investment measure upon which benefits are determined, or reductions of existing benefits, also are not treated as material modifications. Thus, for example, the removal of a callable right with "haircut" provision generally would not constitute a material modification. The Notice also indicates that amending an arrangement to stop future deferrals is not a material modification.
- **Amendments to Terminate Plan and Distribute Benefits are not Material Modifications.** Importantly, the Notice further provides that amending an arrangement on or before December 31, 2005 to terminate the arrangement and distribute the amounts of deferred compensation thereunder will not be treated as a material modification provided that all amounts deferred under the plan are includable in income in the taxable year in which the termination occurred.
- **Amendments to Permit Participants to Elect on or before December 31, 2005 to Terminate Participation and Receive Distributions or Cancel their Deferral Elections are Allowed.** The Notice further states that a plan may be amended by December 31, 2005 to allow a participant during calendar year 2005 to terminate participation in the plan or cancel a deferral election with regard to earned and vested amounts deferred in 2005 that are subject to Section 409A, provided that (i) the amendment is adopted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includable in income of the participant in 2005. There is no requirement that the opportunity to terminate participation in the plan or to cancel a deferral election be granted to all plan participants. The Notice states that the fact that participants are given this election will not cause them to be in constructive receipt of their benefits.

Special Transitional Relief For Deferral Elections

Section 409A generally requires that elections to defer compensation be made prior to the begin-

ning of the service provider's taxable year in which the services are performed.

- **Exemption for Certain Deferral Elections Made Before March 15, 2005.** The Notice states, however, that the requirements under Section 409A relating to the timing of elections do not apply with respect to amounts earned for services performed on or before December 31, 2005, if the elections are made on or before March 15, 2005 and the following requirements are met: (i) the amounts to which the deferral election relates have not been paid or become payable at the time of election, (ii) the plan under which the deferral election is or was made was in existence on or before December 31, 2004, (iii) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005, (iv) the plan is otherwise operated in accordance with Section 409A with respect to deferrals subject to that provision, and (v) the plan is amended to comply with the requirements of 409A. For these purposes, a plan is considered to have been in existence before December 31, 2004 if the plan is adopted on or before December 31, 2004.

"The requirements …do not apply with respect to amounts earned for services performed on or before December 31, 2005, if the elections are made on or before March 15, 2005 [and certain requirements are met]."

- **Temporary Definition of Performance-Based Compensation.** Section 409A provides that elections to defer "performance-based compensation" that is based on performance over a period of at least 12 months, may be made at any time until 6 months before the end of the performance period. The Notice further provides that until additional guidance is issued, a deferral election for an annual bonus will be treated as meeting the requirements of "performance based compensation" if payment of the compensation is contingent on the satisfaction of corporate or individual performance criteria and the performance criteria are not substantially certain to be met at the time a deferral election is permitted. Subjective performance criteria may be used for this purpose, if the criteria used relate to the participant, a group of employees, or a business unit for which the employee provides services.

Temporary Exemption for Elections Tied to Qualified Plan Elections.

The Notice also states that for periods ending on or before December 31, 2005, an election under a nonqualified deferred compensation plan that is controlled by a payment election made by the participant under a qualified plan will not violate Section 409A, as long as the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that govern payments.

Good Faith Compliance and Time for Retroactive Amendments

- **General Rule.** A plan adopted before December 31, 2005 will not be treated as violating Section 409A if the plan is operated in good faith compliance with the provisions of the new laws and the Notice during the calendar year 2005 and is amended on or before December 31, 2005 to conform to the provisions of Section 409A with respect to amounts subject to that provision.
- **Retroactive Changes to Payment Elections Allowed if Made Before December 31, 2005.** A plan may be amended to provide for new payment elections with respect to amounts previously deferred, and the election will not be treated as a change in the form or timing of payment of benefits, in violation of Section 409A(a)(4), if the plan is amended and the participant makes the election on or before December 31, 2005.

- **Revisions to Certain Equity Awards.** Similarly, outstanding stock options and stock appreciation rights that are deemed to provide for a deferral of compensation may be amended to provide for fixed payment terms, or to permit holders of such rights to elect fixed payment terms consistent with Section 409A, without being deemed to violate the provisions of Section 409A, as long as the amendment or election is made on or before December 31, 2005.

"Until further guidance is issued, severance arrangements that provide benefits that are not otherwise exempt…should be operated in a way that complies with Section 409A."

- **Temporary Exemption for Certain Severance Pay Plans.** The Notice further states that a plan that is amended to comply with Section 409A on or before December 31, 2005, will not be subject to the Section 409A requirements during calendar year 2005 if it qualifies as a "severance pay arrangement" under ERISA, and is either collectively bargained or covers no "key employees" as defined in Section 416(i) of the Code (which generally includes officers earning in excess of $130,000, 5% owners, and 1% owners earning in excess of $150,000) of the employer. The Notice states that benefits provided under a severance pay arrangement under ERISA will always constitute severance pay for these purposes if the benefits are payable only if the participant's termination of employment is involuntary. The Notice requests comments to as whether Section 409A should apply to severance payments, including whether to exclude specific types of severance plans or arrangements. Until further guidance is issued, severance arrangements that provide benefits that are not otherwise exempt from Section 409A should be operated in a way that complies with Section 409A. Thus, for example, those plans should not permit participants to elect to defer, or change the time or form of, payment of their benefits unless those elections comply with Section 409A.

  Benefits conditioned upon involuntary severance that are paid as a lump sum within 2½ months after termination of employment should be exempt from Section 409A under the rule for short-term deferrals discussed above.

Information Reporting Requirements for Deferred Amounts

The Act requires that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 (miscellaneous income) or a Form W-2, regardless of whether the compensation is includable in gross income pursuant to Section 409A. The Notice indicates that the information reporting requirements apply not only to account balance plans but also to nonaccount balance plans, but that amounts deferred under nonaccount balance plans are not required to be reported until the deferrals become reasonably ascertainable. The Notice also states that until further guidance is provided, if the aggregate amount of deferrals for the year with respect to an individual under all nonqualified deferred compensation plans does not exceed $600, then those deferrals need not be reported. The Notice indicates that the information reporting requirements are effective only for amounts actually deferred in calendar years beginning after December 31, 2004, and that for those purposes, an amount will not be considered to have been actually deferred until the employee has a "legally binding right" to the compensation. The Notice indicates that additional guidance with regard to these information reporting requirements will be forthcoming.

Wage Withholding

The Notice provides that for the calendar year 2005, amounts includable in gross income under Section 409A but which are not otherwise actually or constructively received by an employee may be treated as having been paid by an employer for withholding tax purposes on any date on or before December 31, 2005. If, however, the amount becomes subject to withholding on some earlier date under any other provision of the law, then withholding will be required to be made in accordance with that provision.

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- Entertainment
- Environmental
- Executive Compensation and Employee Benefits
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- Financial Institutions
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- Government Contracts
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