

Section 409A: The How, What and When of Amending Deferred Compensation Arrangements

Jonathan Wolfman, A. William Caporizzo, Amy Null

Linda Sherman, Kimberly Wethly

November 8, 2005

Overview of Seminar

Refresher on FAS 123R

Summary of Section 409A

Panel Discussion on 409A

Checklist and Timeline

Questions and Answers

Refresher on FAS 123R

FASB issued the final version of FAS 123R on December 16, 2004

- Public companies are required to adopt FAS 123R by their first fiscal year beginning after June 15, 2005
- Nonpublic companies are required to adopt FAS 123R by their first fiscal year beginning after December 15, 2005

Clarifications continue to be made (e.g., grant date issue)

Refresher on FAS 123R

Highlights

- Fair value of stock-based awards treated as a compensation expense
- Expense previously required solely in footnotes to financial statements
- FASB prefers binomial and “lattice-based” valuation model, but will permit use of closed-form models (such as Black-Scholes) for public companies
- FASB to permit use of calculated value approach for determining fair value for nonpublic companies
- Applies to all options that vest after adoption, even if granted before that date

Implementing FAS 123R

Accelerate underwater options before December 31, 2005?

- Pro: eliminates charge for options with no incentive/retentive value
- Cons: investor relations, lose incentive/retentive value of those options if stock price rises
- Crux: how far underwater should the options be before acceleration is recommended?

Summary of Section 409A

Implements sweeping changes to taxation of non-qualified deferred compensation

- Applies broadly to all agreements, plans and arrangements that provide for the deferral of compensation
- Dictates permissible distribution events
- Establishes timing of deferral/distribution elections

Effective Date

Applies to amounts deferred or vested after December 31, 2004

- Pre-2005 deferrals are “grandfathered” if earned and vested on or before December 31, 2004 and service provider has a legally binding right to be paid
- Grandfathered deferrals become subject to 409A if the plan is materially modified after October 3, 2004

Guidance

- Notice 2005-1, issued December 20, 2004
- Proposed Treasury regulations, released September 29, 2005

Effective Date

Transition rules

- Good faith compliance required as of January 1, 2005
- Documentary compliance and some transition relief extended until December 31, 2006
- 2005 year-end action items remain

Why Comply with 409A?

Drastic consequences to employees

- Income inclusion for deferred amounts as soon as no longer subject to a “substantial risk of forfeiture”
- 20% penalty tax imposed on employee
- Interest at underpayment rate plus 1%

Reporting and withholding obligations for employers

Non-qualified Deferred Compensation Plan

A deferral of compensation exists when there is a “legally binding right” during a tax year to compensation that (i) has not been actually or constructively received and included in gross income and (ii) that is payable in a later tax year

- Includes: salary/bonus deferrals, options and SARs with below-market exercise prices, some employment, severance and change in control agreements and SERPs or excess benefit plans
- Excludes: tax-qualified plans, vacation, sick leave, death and disability benefits, most options and SARs with fair market value exercise prices, ESPPs, restricted stock, short-term deferrals and certain foreign plans

Distribution Rules

Permissible distribution events

- A specified date or pursuant to a fixed schedule
- Separation from service (with a six-month delay for “key employees” of public companies)
- Change in control of a corporation
- Death
- Disability
- Unforeseeable emergency

Acceleration of distributions prohibited

- Acceleration of vesting permitted
- Other exceptions

Deferral Elections

New election rules

- Specify the timing of elections
- Require election to include time and form of distributions

Initial election

- Must be made in the calendar year prior to the year in which the services with respect to the compensation are performed
- For performance-based compensation earned over at least 12 months, must be made 6 months before end of service period
- For newly eligible participants, must be made within 30 days
- For ad hoc awards requiring at least 12 months of service, must be made within 30 days and at least 12 months before end of service period
- Special rules for non-calendar year service providers

Deferral Elections

Subsequent elections

- Cannot take effect until at least 12 months after the date of the election
- Must provide for an additional deferral of at least 5 years (except in the case of death, disability and unforeseeable emergency)
- If related to a payment on a specific date or pursuant to a fixed schedule, must be made at least 12 months prior to the first scheduled payment

Exception: Short-Term Deferrals

Compensation is not subject to 409A if paid before the later of

- 2½ months after the end of the employee's tax year in which the amount is no longer subject to a substantial risk of forfeiture, and
- 2½ months after the end of the employer's tax year in which the amount is no longer subject to a substantial risk of forfeiture

Written plan not required for short-term deferrals, but recommended

Deferrals of otherwise qualifying amounts must comply with subsequent deferral election rules

Exception: Certain Equity Awards

Generally, the following equity-based awards are exempt from 409A

- Restricted stock and restricted stock units (RSUs) that pay out on vest
- Other awards that are paid within the short-term deferral period
- Stock options and SARs with a fair market value exercise price
 - Must be for “service recipient stock”
 - Fair market value safe harbors

Modifications, deferral features may make otherwise exempt awards subject to 409A

Performance-Based Compensation

For services performed over a period of at least 12 months, employee may make an initial election up to 6 months before the end of the service period

- Definition of performance-based compensation
 - Contingent upon satisfaction of pre-established organizational or individual performance criteria (including subjective criteria)
 - Criteria may be established up to 90 days after start of service period
 - No requirement that board or shareholders approve
- Performance tied to value of service recipient stock
 - Notice 2005-1 prohibited as criteria
 - Proposed regulations permit as criteria subject to certain rules

Separation Pay

Separation pay arrangements must comply with 409A, with the following exceptions

- Payments upon **involuntary** separation or pursuant to a window program
 - Limited to 2X employee's annual compensation or, if less, 2X the contribution limit for qualified plans (\$210,000 for 2005), and
 - Must be paid before the end of the second calendar year following the year of the separation
- Certain reimbursements and *de minimis* amounts
 - Generally limited to otherwise deductible expenses (e.g., business expenses and medical expenses)
 - Must be paid before the end of the second calendar year following the year of separation

No exception for separation pay arrangements upon voluntary or “good reason” terminations

Separation Pay: Key Employees

Distributions to “key employees” of public companies must be delayed 6 months following separation from service

- Generally, key employee has same definition as for top-heavy rules under tax-qualified plans
- Proposed regulations establish identification period for key employees
- Six-month delay may be implemented by
 - Aggregating payments due during first 6 months and paying in 7th month, or
 - Commencing payments in 7th month

Merger & Acquisition Issues

Many typical deal features are affected

- Separation and change in control payments
- Assumption/substitution of stock rights
 - Notice/ proposed regulations include safe harbor where aggregate spread is maintained and no additional benefits provided
- Earnouts/escrows
 - Proposed regulations include safe harbor where payments to holders of stock rights are made on the same schedule as payments to shareholders and are made within 5 years
- Retention/bonus plans
 - Must comply with 409A

Non-qualified Plans Linked to Qualified Plans

Proposed regulations include helpful rules to avoid violations of 409A for non-qualified plans linked to qualified plans

- Rules apply to non-qualified plans that offset qualified plan benefits or that provide benefits in excess of qualified plan limits
- No deferral election is made if in connection with such plans
 - There are changes to qualified plan limits
 - An employee elects subsidized or ancillary qualified plan benefits, or there is an addition or removal of a benefit
 - An employee makes a deferral election under a 401(k) plan that affects a deferral or match under a wrap if the non-qualified plan deferral does not exceed 402(g) limits

Other Issues

Proposed regulations also address

- Foreign plans and other international issues
- Certain partnership issues
- Plan aggregation rules

Proposed regulations do not address

- Reporting issues
- Calculation of deferred amount (other than grandfathered amount)
- Taxation of stock rights subject to 409A
- Prohibition on use of offshore trusts

Transition Rules: What You Should Be Doing Now

Identify plans and arrangements subject to 409A

- Determine which plans are and are not grandfathered
- Develop procedure for tracking grandfathered plans

Operate plans in good faith compliance with 409A

- Reliance on statute, Notice 2005-1 and/or proposed regulations
- Good faith, reasonable interpretations required for unaddressed issues

Transition Rules: What You Should Do by Year End

Identify plans and arrangements to terminate

- Notice 2005-1 permits employers to terminate plans, in whole or in part, in 2005 provided any required amendments are documented in 2005 and amounts are included in income in 2005 (or when vested)
- This relief was not extended by the regulations

Cancel deferral elections

- Notice 2005-1 allows employers to permit employees to cancel all or part of their deferral elections in 2005
- This relief was not extended by the regulations

Collect deferral elections for 2006 compensation

- Elections to defer compensation attributable to non-performance-based services performed in 2006 must be made by December 31, 2005

Transition Rules: What You Should Do by Year End

Correct discounted stock rights, maybe

- Stock rights that were discounted at grant and were not vested on or before December 31, 2004 may be replaced with stock rights that are exempt from 409A until December 31, 2005
 - Regulations include permissible methods to compensate employees in 2005 for lost discount
- This relief was extended until December 31, 2006, however, the exercise of a right in 2006 before replacement will violate 409A and any payments in 2006 to compensate for the lost discount will be subject to 409A

Prepare for reporting of deferred amounts

Transition Rules: What You Should Do in 2006

Bring plans into written compliance

- The deadline for bringing plans into written compliance (and documenting unwritten plans) was extended until December 31, 2006
- Amendments may allow employees to change the form and/or timing of payments, however, modifications of grandfathered plans will result in the application of 409A to those plans
- Amendments may not accelerate a payment into 2006 or defer an amount otherwise payable in 2006

How to Contact Us

A. William Caporizzo

William.caporizzo@wilmerhale.com

617 526 6411

Amy Null

Amy.null@wilmerhale.com

617 526 6541

Linda Sherman

Linda.sherman@wilmerhale.com

617 526 6712

Kimberly Wethly

Kim.wethly@wilmerhale.com

617 526 6481

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