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## Initial Guidance on Section 409A: Taxation of Nonqualified Deferred Compensation

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The Internal Revenue Service released Notice 2005-1 on December 20, setting forth its initial guidance under new Code Section 409A regarding the taxation of nonqualified deferred compensation, including certain equity awards. To the extent that Section 409A's strict operational and documentary requirements are not satisfied, the service provider is generally currently taxable on deferred compensation, with interest, and must pay an additional 20% tax. This alert summarizes the guidance set forth in the Notice and highlights issues that are of concern as the January 1, 2005 effective date nears. A more comprehensive summary of these and other issues addressed by the Notice and how your compensation programs may be affected, will be available at our website at [www.wilmerhale.com](http://www.wilmerhale.com) under "Recent Publications."

### What Arrangements Are Affected by the New Rules?

The threshold question is whether a given compensatory arrangement constitutes "deferred compensation" subject to the new regime. As noted in our previous [alert](#), the legislative history of Section 409A broadly defines a nonqualified deferred compensation plan as any plan that provides for the deferral of compensation, with very limited exceptions. While there continue to be significant questions regarding the scope of Section 409A, the Notice provides the following rules:

*A. Certain Compensatory Awards Are Not Treated as Deferred Compensation.* The following are exempt from 409A:

- ISOs and ESPPs. Incentive stock options and options granted under an employee stock purchase plan complying with the terms of Code Section 423;
- NQSOs Granted at FMV. Nonqualified stock options that have an exercise price equal to or above the fair market value and that have no deferral feature (other than the right to decide

when to exercise); however, the presence of an option gain deferral feature subjects the option to Section 409A;

- Public Company SARs. Stock-settled stock appreciation rights (SARs) granted by public companies if (i) the measurement floor for appreciation is at least the fair market value on the grant date and (ii) there is no deferral feature (other than the right to decide when to exercise);
- Restricted Stock, RSUs, DSUs and Other Awards That Payout on Vesting. Restricted stock, restricted stock units (RSUs), deferred stock units (DSUs) and other awards that pay out on vesting, unless there is a deferral feature extending the settlement date beyond the vesting date; however, it appears that the presence of a deferral feature subjects the award to Section 409A;
- Bonuses. Bonuses paid by the later of (i) 2½ months after the end of the service provider's tax year in which any risk of forfeiture on the payment lapsed and (ii) 2½ months after the end of the service recipient's tax year in which any risk of forfeiture on the payment lapsed *and* bonuses or other arrangements where the service recipient has the unilateral right to reduce or eliminate the payments;
- Service Providers. Arrangements with service providers (other than employees and directors) who provide services to multiple unrelated clients, and arrangements between accrual-based taxpayers; and
- Certain Benefit Plans. Qualified plans (such as 401(k) plans, 403(b) plans and 457(b) plans for tax exempt entities [but not 457(f) plans]), health savings and reimbursement accounts, and bona fide vacation, sick leave, compensatory time, disability and death benefit plans.

**B. Interim Relief for Certain Other Compensatory Arrangements.** The Notice provides transition relief for certain arrangements:

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Interim Relief for Certain Other SARs. Until further guidance is issued, a payment of cash or stock on exercise of an SAR or in cancellation of an SAR granted pursuant to a plan in effect on or before October 3, 2004 will be exempt from Section 409A if (i) the measurement floor for appreciation is at least the fair market value on the grant date and (ii) there is no deferral feature (other than the right to decide when to exercise);

- Partnership Interests. Until further guidance is issued, awards of partnership profits interests and capital interests will be exempt from Section 409A;

*C. Other Rules.* Significantly, the acceleration of vesting of an otherwise excluded equity award will not cause the award to become nonqualified deferred compensation (NQDC) subject to Section 409A. Moreover, an adjustment made to otherwise excluded options to reflect a corporate transaction will not cause the application of Section 409A, provided that the adjustment does not increase the value to the service provider. In addition, while the Notice does not directly address the issue, option cash-out payments in corporate transactions generally should not be treated as NQDC, provided that the amounts are paid shortly after vesting. Finally, the issue of whether a service recipient's right or obligation to repurchase vested shares received under an equity award will cause an otherwise excluded award to be treated as NQDC is under consideration. The Notice does not indicate, however, whether any such rule would extend to the withholding of shares for the payment of taxes.

### **Definition of Substantial Risk of Forfeiture**

NQDC for which the operational and documentary requirements of Section 409A have not been satisfied is included in the income of the service provider in the tax year in which such compensation fails the 409A requirements, if it is no longer subject to a substantial risk of forfeiture. The Notice provides that a substantial risk of forfeiture exists where entitlement to compensation is conditioned upon either the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial (i.e., no risk of forfeiture exists if enforcement is unlikely). Significantly, the Notice provides that a non-compete will not constitute a substantial risk of forfeiture. In addition, rolling deferrals (that is, extensions of the risk of forfeiture) will not constitute substantial risks of forfeiture.

### **Effective Date**

In general, Section 409A applies to compensation deferred after December 31, 2004, and to amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. The Notice provides that an amount is considered deferred before January 1, 2005 if (i) the service provider has a legally binding right to the amount and (ii) the amount is earned and vested (that is, the amount is not subject to a substantial risk of forfeiture or to a requirement to perform future services).

*Actions That Are Treated as Material Modifications.* The following will be treated as material modifications:

- Additions of New Benefits and Certain Exercises of Discretion. The enhancement of a benefit or right existing as of October 3, 2004, or the addition of a new right, even if that enhancement or addition is as a result of the service recipient's exercise of discretion under the plan; however, a service recipient may exercise discretion over the time and manner of payment of a benefit to the extent such discretion exists in the plan as of October 3, 2004;
- Accelerating Vesting into 2004. The exercise of discretion by a service recipient to accelerate vesting of a benefit under a plan to a date on or before December 31, 2004; and
- Certain New Grants under Existing Plans. The grant of a new arrangement or additional benefit under a plan existing on October 3, 2004, unless the service recipient can demonstrate consistency with historical compensation practices.

*Actions That Are Not Treated as Material Modifications.* The following will not be treated as material modifications:

- Freezes or Terminations of Plans. Amending a plan to prohibit future deferrals under the plan or terminating a plan on or before December 31, 2005, provided that all amounts under the plan are distributed and included in income in the year of termination;
- Exercises of Discretion by Service Provider. The exercise by a service provider of a right permitted under the plan, to the extent such right exists in the plan as of October 3, 2004;

- Qualifying Replacement Option and SARs. The replacement of an option or SAR with a deferral feature with a new option or SAR, provided that the new option or SAR would not have constituted a NQDC arrangement under the rules described above and certain other requirements are satisfied; and
  
- Amendments to Comply with Section 409A. Amendments to bring the plan into compliance with Section 409A, unless such amendments provide an enhanced or additional benefit to participants (even if such benefit is permissible under Section 409A).

### **Transition Relief**

The Notice provides generous transition relief that, in most cases, allows service recipients until December 31, 2005 to revise documents to comply with Section 409A. Moreover, while Section 409A requires that elections to defer compensation must occur in the year before the services are to be performed, the Notice provides that, for services to be performed on or before December 31, 2005, the requirements of Section 409A will be considered satisfied if the deferral election is made on or before March 15, 2005, provided that the plan under which the deferral is made was in existence on December 31, 2004, the plan is otherwise operated in accordance with Section 409A, the plan is amended on or before December 31, 2005 to comply with Section 409A, and certain other requirements are satisfied.

In addition, until further guidance is issued (which is expected to be more restrictive), a deferral election with respect to bonus compensation based on services performed over a period of at least 12 months will be considered to satisfy the requirements of Section 409A if such election is made at least six months before the end of the service period and the payment of compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria that are not substantially certain to be met at the time of the election.

Finally, the requirements of Section 409A are not required to be satisfied during calendar year 2005 with respect to collectively bargained severance and severance for employees who are not "key employees," as long as (i) the severance is less than twice an individual's prior year compensation and is paid in less than two years or (ii) the severance is paid only on involuntary terminations.

### **Scope of Guidance and Comments**

The Notice also defines change in control for purposes of Section 409A, sets forth certain permitted acceleration events for NQDC and provides initial guidance on the withholding and information reporting requirements applicable to NQDC.

The Notice states that it is the first in a series of expected guidance. The Notice further states that future guidance may, in some cases, be more restrictive, although any such guidance is intended to be prospective only. Moreover, the Internal Revenue Service and Treasury are specifically seeking comments on several topics, including the application of Section 409A to severance plans and to arrangements involving partnerships, the treatment of foreign funding vehicles, potential exclusions for arrangements among businesses and additional situations in which accelerated payment of deferred amounts may be appropriate.

For more information on the new guidance and how it applies to your compensation programs, please contact:

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