THE NEW DEFERRED COMPENSATION RULES

FEBRUARY 11, 2005

This memorandum is a supplement to our memorandum dated October 28, 2004, entitled, "Responding to the New Deferred Compensation Legislation", regarding Section 409A of the Internal Revenue Code. On December 20, 2004 and January 5, 2005, the Department of the Treasury ("Treasury") issued guidance, in the form of Questions and Answers (the "Q&As"), in an effort to clarify certain provisions of new Section 409A. While this guidance answers many questions regarding the application of Section 409A, Treasury has acknowledged that significant additional guidance is required and has indicated that such guidance will be provided by June of 2005. Please note that in order to ensure full compliance with Section 409A, companies need to begin to act now.

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I. INTRODUCTION TO THE NEW RULES

A. Compensation Arrangements Targeted by Section 409A

Section 409A places significant practical restrictions on deferred compensation arrangements covering employees, non-employee directors, independent contractors and personal services corporations (collectively, "service providers"). Section 409A (as amplified by the Q&As) is broad in scope and, pending additional guidance, generally defines the term "deferred compensation" as any plan or arrangement that has the effect of deferring payment of compensation beyond the later of: (i) March 15 of the year following the year in which the compensation became earned and vested by the service provider; or (ii) 2½ months after the end of the fiscal year of the person for whom the services were performed (the "service recipient") in which the compensation became earned and vested by the service provider. Such arrangements generally include any of the following types of arrangements (collectively, the "Covered Plans"):

- Stock options with an exercise price that is less than the fair market value of the underlying stock on date of grant
- Stock appreciation rights (subject to limited exceptions described below)
- Restricted stock units and other similar phantom equity awards with deferred payments/settlement dates beyond the vesting dates
- Supplemental executive retirement plans ("SERPs"), excess benefit plans and nonqualified deferred compensation arrangements
- Certain severance pay arrangements, including employment agreements and severance plans
- Annual or multi-year bonus plans with deferred payouts

B. Scope of Section 409A

Subject to the exceptions described in Sections III and V below, Section 409A generally applies to all compensation that is:

- deferred beginning after December 31, 2004; or
- deferred beginning before January 1, 2005, if the plan under which the deferral is made is "materially modified" after October 3, 2004.

A plan is considered to be "materially modified" if any existing benefit or right provided under the plan is enhanced, a new benefit or right is added, or a new plan is adopted. Please note that a grant of an award (i.e., a stock option) constitutes the adoption of a new plan.

The Q&As also provide that Covered Plans fall into one of three categories. They are:

(i) Nonaccount balance plans (e.g., defined benefit SERPs);

(ii) Account balance plans (e.g., traditional salary or bonus deferral plans with an annual earnings feature); or

(iii) "Other" plans, which currently appears to refer to equity-based compensation plans.

Under the Q&As, a severance pay arrangement can be either a nonaccount balance plan or an account balance plan, depending on the characteristics of the arrangement.

C. Timing of Payment of Deferred Compensation

In order to comply with the provisions of Section 409A, the payment of the compensation that is deferred must be designed so that the payment commences upon the occurrence of one or more specified events, established in advance under the Covered Plan. These specified events are limited to the following:

- a specified date (or on a schedule of specified dates);
- the service provider's separation from service, with a mandatory six-month post-separation delay for "key employees" of public companies (defined generally as the top 50 officers (who earn at least $135,000 per year), any one-percent stockholder who also earns more than $150,000 annually, and any five-percent stockholder, of a service provider);
- the service provider's death;
- in limited circumstances, the service provider's disability or upon an unforeseeable emergency;
- in order to satisfy a domestic relations order, conflicts of interest requirement or payment of employment taxes; and
- certain change in control events (please note that these change in control events are only applicable to corporations, and are limited to, generally, a change in ownership of a specified percentage of stock, a change in effective control, or a change in ownership of a substantial portion of assets, of the corporation).

Also, under Section 409A, no acceleration of the payment of any deferred compensation is permitted, except upon one of the foregoing specified events, or if the total payment is not greater than $10,000 and such payment occurs within a specified time period.

D. Timing of Deferral Elections

In addition to the foregoing payment requirements (but subject to the transition rule pertaining to deferral elections described in Section II.A below), all deferral elections for compensation earned after calendar year 2004 must be made before the beginning of the year in which the services to which the deferred compensation relates are performed. However, two exceptions to this rule exist:

- if the deferred compensation is "performance-based bonus compensation" (which, pending further guidance, the Treasury has defined rather liberally) and payable in respect of services to be performed over at least a 12-month period, the deferral election may be made as late as six months before the end of the performance period; and

- an initial deferral election may be made within 30 days after the date the service provider first becomes eligible to defer the compensation in question, but only with respect to amounts earned after the election is made.

In addition to the requirements discussed above, if a service provider wishes to redefer any previously deferred compensation, Section 409A requires that such redeferral satisfies the following rules:

- The redeferral election is made not less than 12 months before the scheduled payment of the previously deferred compensation;

- The redeferral election is effective no earlier than 12 months after it is made; and

- The redeferred compensation may not be payable for at least an additional five years (or, if earlier, upon the service provider's death, disability or an unforeseeable emergency).

E. Consequences of Being Treated as Deferred Compensation under, but Failing to Satisfy the Requirements of, Section 409A

The consequences of compensation being treated as deferred compensation under Section 409A, but failing to satisfy the requirements of Section 409A, are:

- immediate taxation to the service provider as soon as the compensation is earned and vested (whether or not the service provider would otherwise be eligible to receive it under the applicable plan);
- an incremental 20% tax being imposed on the amount of the deferred compensation; and
- interest (at the tax underpayment rate plus one percentage point) also being imposed on the amount of the deferred compensation, retroactive to the date the compensation was earned and vested.

All such taxes and interest are payable by the service provider. If the service provider is an employee, the service recipient (the employer) will have tax withholding obligations with respect to the compensation being taxed under Section 409A. Note that Section 409A imposes annual reporting obligations on all service recipients with respect to all deferred compensation, whether or not such deferred compensation is includible in a service provider's income for the year.

The Q&As also contain an additional critical rule: in the event that *one* Covered Plan of a certain category (see Section I.B for a description of the three categories of Covered Plans) fails to satisfy the requirements of Section 409A, compensation that is deferred under *any other Covered Plan of the same category,* other than grandfathered or otherwise exempt plans, is also deemed to fail the requirements of Section 409A.

Example:

An individual is entitled to receive benefits, which he earned while an employee of Company A, payable under a defined benefit SERP that complies with Section 409A. The individual ceases to be an employee of Company A, and receives severance under an arrangement that does not comply with Section 409A. Under the Q&As, this individual would be required to recognize as income all non-grandfathered amounts payable under the severance arrangement and the SERP, and the 20% tax (plus interest) would be imposed on all such amounts.

As indicated above, deferred compensation that was fully vested and earned by December 31, 2004 under a Covered Plan that is not subsequently materially modified is grandfathered; i.e., it is unaffected by Section 409A. In addition, Section 409A and the Q&As identify arrangements that, although they technically constitute deferred compensation, are exempt from the application of Section 409A (See Sections III and V, below).

II. KEY DEADLINES

A. Deferral Elections: March 15, 2005 Election Deadline

Deferrals of compensation that are otherwise subject to Section 409A may be made up to (or changed by) March 15, 2005, if they affect compensation relating in whole or in part to services performed on or before December 31, 2005, and still be exempt from the new rules regarding the timing of deferral elections under Section 409A, so long as the following criteria are satisfied:

- the election is being made under the terms of a Covered Plan in effect on or before December 31, 2005, and affects amounts that have not yet been paid or become payable; and
- the plan under which the deferral is being made was in existence on or before December 31, 2004 (meaning there existed a written document specifying the amount or type of compensation subject to the plan and eligible for deferral

thereunder) and, on or before December 31, 2005, is amended to comply with Section 409A.

Note that the March 15, 2005 deadline raises immediate compliance issues with respect to deferrals made under unfunded excess benefit (or "spillover") plans, many of which allow plan participants to increase their deferral elections throughout a given year, either directly under the plan or indirectly pursuant to the tax-qualified defined contribution plan upon which the excess benefit plans are based. Currently under the Q&As, any such increases made after March 15, 2005, would appear to cause the excess benefit plans to fail to comply with Section 409A.

B. Compliance Alternatives

Service recipients who wish to bring their Covered Plans into compliance with Section 409A must do so by no later than December 31, 2005. The Q&As provide two basic approaches to compliance with Section 409A. The first is to amend, if necessary, a non-grandfathered deferred compensation plan by the end of 2005 to conform to the Section 409A rules, and the second is to cancel a non-grandfathered deferred compensation plan, causing the service provider to recognize the otherwise deferred amount as income, both as outlined below. These compliance alternatives may be selected on a plan-by-plan, or even person-by-person, basis.

- ***Alternative #1: Conform to Section 409A***. Section 409A requires two elements of compliance. First, the written terms of the deferred compensation plan must conform to the requirements of Section 409A. Second, the plan must in fact be administered in conformity with such requirements. The Q&As provide that the deadline for amending the written terms of any plan that does not conform to Section 409A is December 31, 2005. If this method of compliance is utilized, the plan must, <u>for all of 2005</u>, be administered in conformity with Section 409A. For this purpose, the Q&As establish a "good-faith" compliance standard.

- ***Alternative #2: Cancel Deferral Elections and/or Covered Plans***. Alternatively, deferral elections and/or deferred compensation plans may be cancelled in whole or in part, in which case the plan participants must recognize the otherwise deferred amounts as income in the later of (i) calendar year 2005 or (ii) the year in which the deferred amounts become earned and vested.

III. TRANSITION RULES: EXEMPT ARRANGEMENTS

The following sets forth the transition rules established under the Q&As, which exempt certain compensation from being considered deferred compensation under Section 409A.

A. Stock Appreciation Rights

Until further guidance is issued, a payment of stock or cash upon exercise of a stock appreciation right will not be subject to taxation under Section 409A, <u>if</u> such right:

(i) was granted pursuant to a program (which term is not formally defined in the Q&As, but appears to refer to historical practices, automatic formula grants and other similar arrangements) in effect on or prior to October 3, 2004;

(ii) has an exercise price at least equal to the fair market value of the stock underlying the stock appreciation right on the date of grant (Treasury has indicated that it intends to issue further guidance on how the “fair market value” of stock is to be determined); and

(iii) does not contain any feature allowing for any additional deferral of compensation.

B. Severance Pay Arrangements Not Covering Key Employees

During 2005, a service recipient may pay severance benefits to service providers under severance arrangements that do not comply with Section 409A, if such severance arrangements do not cover key employees (as such term is defined in Section I.C above).

C. Certain Deferrals Linked to Qualified Retirement Plan Elections

Payments of deferred compensation made or (in the case of installment payments) commenced on or before December 31, 2005 under nonqualified deferred compensation plans that are controlled by a payment election made by a plan participant under a tax-qualified retirement plan will not be subject to taxation under Section 409A, <u>so long as</u> the payment of such deferred amounts is made in accordance with the terms of the nonqualified plan as in effect on October 3, 2004 and is made or commences on or before December 31, 2005. This exception is intended to protect SERPs that pay out benefits in accordance with elections made under the qualified retirement plans to which they relate.

IV. ARRANGEMENTS THAT ARE SUBJECT TO TAXATION UNDER SECTION 409A

Generally, the following forms of compensation will be subject to taxation under Section 409A, assuming they are not otherwise grandfathered or exempt:

A. Discounted and Other Stock Options

- Any stock options having an exercise price that is less than the fair market value of the stock underlying the option on the date of grant of the option.
- Any nonqualified stock options having an exercise price equal to the fair market value of the stock underlying the option, which has an additional feature allowing for the deferral of compensation.

B. Certain Stock Appreciation Rights

Any stock appreciation rights which are not exempt under the transition rules (as described in Section III above) or otherwise do not comply with Section 409A (as described in Section V.B below).

C. Certain Restricted Stock Units and Other Similar Equity Awards

Any restricted stock units or other similar equity awards that vest in installments, if payment of such awards is not made within 2 ½ months after the applicable taxable year in which the awards vest (e.g., an award vests 20% annually but the underlying shares are not distributed until the award is 100% vested).

D. Certain Severance Pay Arrangements

Until further guidance is issued, severance payable after 2005 under any arrangement (whether an employment agreement or a severance plan) for any employee (whether a key employee or otherwise) that does not comply with the payment provisions of Section 409A. Severance pay arrangements, however, present immediate practical issues now, particularly where a severance payment period extends beyond 2 ½ months after the applicable taxable year, and therefore such payment is potentially subject to Section 409A.

Example:

Facts. A senior officer of a public company is terminated from employment in March 2005. Under the officer's employment agreement with the company, the senior officer is entitled to two years of salary continuation.

Analysis. Assuming, as the Q&As (and Section 409A itself) imply, that severance benefits are a form of deferred compensation, this deferred compensation only becomes vested in 2005, because, absent unusual facts, executives only receive severance if they are involuntarily terminated, and have no right to severance if they voluntarily resign.

Because the full severance benefit is therefore subject to Section 409A, the company and senior officer are faced with an immediate Section 409A compliance issue and must analyze their compliance strategy. If the severance is merely paid out in accordance with its terms, the officer arguably will be subject to taxation on the entire severance amount in 2005, plus an additional 20% income tax, because the employment agreement violated the rule that deferred compensation payable to a senior officer must not be paid out until six months after termination of employment.

Possible Methods of Compliance Under the Example:

- Delay the commencement of the severance payments for six months.
- Accelerate the severance payments so that they are all paid out by March 15, 2006, based on the theory that the severance is not deferred compensation.
- For 2005 only, a third choice seems to be available. Because, as discussed above, the parties to a Covered Plan can choose to comply in part with Section 409A and to take the remainder of the deferred amount into income during 2005, it appears permissible to pay the first six months of severance in our example in a lump sum and pay the rest of it in installments after six months. Analytically, there is no particular reason why, under this reasoning, the parties in our example could not simply agree to pay the first six months of severance out in installments (as long as all such payments are completed by the end of 2005) and pay the rest of the severance in installments beginning six months later.

E. Other Deferred Compensation

All other compensation that is deferred under Covered Plans that do not comply with the deferral and payment requirements of Section 409A (such as a nonqualified deferred compensation arrangement that provides for distributions upon the occurrence of a transaction that does not meet the change in control definition under Section 409A, or a SERP that provides for the commencement of installment payments immediately upon a termination of employment of a key employee) and which are not otherwise eligible for an exemption under the transition rules.

V. ARRANGEMENTS THAT ARE NOT SUBJECT TO TAXATION UNDER SECTION 409A

Generally, the following deferred compensation should not be subject to taxation under Section 409A:

A. Certain Stock Options

- Incentive stock options (as described in Section 422 of the Internal Revenue Code) and options under employee stock purchase plans satisfying the requirements of Section 423 of the Internal Revenue Code.
- Nonqualified stock options having an exercise price at least equal to the fair market value of the stock underlying the option on the date of grant, which have no additional features allowing for the deferral of compensation.

B. Public Company Stock Appreciation Rights

Stock appreciation rights that:

(i) have an exercise price at least equal to the fair market value of the stock underlying the stock appreciation right on the date of grant;

(ii) are exercisable only for stock that is traded on an established securities market; and

(iii) which have no additional features allowing for the deferral of compensation.

C. Restricted Property and Partnership Interests

Compensation that is paid in the form of property, such as restricted stock, that is subject to Section 83 of the Internal Revenue Code. Until further guidance is issued, partnership interests (including profits interests) issued to a service provider are not subject to Section 409A.

D. Certain Qualified Plans and Welfare Plans

Benefits payable under any tax-qualified retirement plan, tax-deferred annuity, certain deferred compensation plans that are subject to Section 457 of the Internal Revenue Code, and any vacation or sick leave, disability pay, death benefit plan, health and medical savings accounts, or any other medical reimbursement arrangement that satisfies certain requirements of the Internal Revenue Code.

VI. PROPOSED ACTION ITEMS

Companies should act promptly to ensure that all Covered Plans are in full compliance with Section 409A by December 31, 2005. We recommend our clients take the following actions:

A. Consider March 15, 2005 Election Deadline. Determine whether any additional deferral elections need to be made by the March 15, 2005 deadline.

B. Identify Covered Plans. Identify all Covered Plans and gather all relevant documentation with respect to such plans (including plan documents, grant agreements, and, if no such documents are available, written descriptions of any practices and programs).

C. Implement Compliance Programs. Implement processes through which (i) grandfathered arrangements under Covered Plans can be monitored to ensure an exemption under the transition rules continues to be available and (ii) all other Covered Plans can be amended or terminated by December 31, 2005.

The information set forth in this memorandum is based on both written and oral guidance that we have received from Treasury as of the date hereof. Treasury has, however, requested comments from practitioners on several of the topics addressed above and it is expected that Treasury will issue additional guidance on these topics. Therefore, as new guidance is provided, the analyses contained herein may, and are quite likely to, change, so that companies should reconfirm these analyses as they proceed with their Section 409A compliance efforts.

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If you have any questions about the new deferred compensation rules or would like assistance with any of the actions proposed above, please feel free to call Ken Edgar (kedgar@stblaw.com; 212-455-2560), Alvin Brown (abrown@stblaw.com; 212-455-3033) or Brian Robbins (brobbins@stblaw.com; 212-455-3090).

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