



FENWICK & WEST LLP

# Executive Compensation and Benefits

## Treasury Department Issues Guidance under IRC Section 409A in Notice 2005-1

January 11, 2005

On October 22, 2004, President Bush signed into law the American Jobs Creation Act (the “Act”). The Act created Section 409A of the Internal Revenue Code of 1986 (the “Code”) that provides material changes to the tax treatment of nonqualified deferred compensation plans and arrangements. On December 20, 2004, the United States Treasury Department issued guidance on Section 409A in the form of Notice 2005-1 (the “Notice”).

The key areas in which the Notice provided guidance are outlined below:

### **Definitions**

Section 409A of the Code provides that deferrals of compensation under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met.

- A *deferral of compensation* occurs when an individual has a legally binding right during a taxable year to compensation that (i) has not been actually or constructively received and included in the individual’s gross income and (ii) is payable to such individual in a later taxable year.
- A *nonqualified deferred compensation plan* is any agreement, method or arrangement that provides for the deferral of compensation. The definition includes arrangements that apply to one or more individuals and is not limited to arrangements between an employer and an employee. As noted below, this definition includes discount stock options and discount stock appreciation rights.
- Compensation is subject to a *substantial risk of forfeiture* if entitlement to the amount is conditioned on 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. This is similar to (but broader) than rule that applies under Section 83 of the Code. A forfeiture which would be triggered by the violation of a non-compete agreement is not a substantial risk of forfeiture.

### **Treatment of Stock Options and SARs**

- *Options.* Incentive Stock Options (“ISOs”) and nonqualified stock options (“NSOs”) issued with an exercise price of not less than fair market value (“FMV”) on the date of grant are not considered a deferral of compensation and therefore are not subject to Section 409A. However, NSOs that have an exercise price that is less than the FMV of the stock on the grant date will be subject to Section 409A. For companies that do not have publicly traded stock any “*reasonable valuation method*” may be used for purposes of determining the FMV of the stock at the date of grant. (This needs further definition and should be expanded to have at a minimum a “good faith” standard similar to the valuation standard used for ISOs). In addition, if an arrangement that allows the recipient to defer compensation beyond the later of exercise or disposition of the option, such as arrangements involving options and stock appreciation rights, even an ISO or an NSO with an exercise price that is at fair market value on the date of grant, will be subject to Section 409A. An option that has a feature such as an exercise price that was below FMV on the date of grant or other provision that would otherwise be subject it to Section 409A, will not be subject to Section 409A if it exercised within 2½ months of the of the end of the option recipient’s tax year or the option issuer’s tax year in which the option becomes vested.
- *SARs.* SARs will not be subject to Section 409A provided: (1) the SAR exercise price is not less than the FMV of the underlying stock on the date the SAR is granted and cannot become less than such amount, (2) the stock of

the service recipient subject to the SAR is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement of the SAR upon exercise, and (4) 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 SAR. However, if either: (1) under the terms of the SAR, the exercise price is less than the FMV of the stock on the date of grant, (2) the SAR may be settled upon exercise in a medium other than the traded stock of the service recipient, or (3) there is an agreement or arrangement under which the service recipient will purchase the stock delivered in settlement of the SAR upon exercise, then the grant of the SAR will be subject to Section 409A. (Until further guidance is issued, a payment of cash pursuant to the exercise of an SAR, or the cancellation of such right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be subject to Section 409A if: (1) the SAR exercise price may never be less than the FMV of the underlying stock on the date the right is granted, and (2) the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until it is exercised). An SAR that has a feature such as an exercise price that was below FMV on the date of grant or other provision that would otherwise be subject it to Section 409A, will not be subject to Section 409A if it exercised within 2½ months of the of the end of the SAR recipient's tax year or the option issuer's tax year in which the SAR becomes vested.

- **Corporate Transactions.** In the event of a corporate transaction the substitution of a new option for an outstanding option, or the assumption of an outstanding option, will not cause the substituted or assumed option to be subject to Section 409A provided the number of shares subject to the new option corresponds directly to the number of shares subject to the original option and the ratio of the option price to the FMV 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 FMV of the shares subject to the option immediately before the substitution or assumption (as in the manner described in the Treasury Regulations for substitution or assumption of ISOs in a merger). A corporate transaction is defined in the Notice as either: (1) a change in ownership of the corporation, (2) a change in effective control of the corporation or (3) a change in the ownership of a substantial portion of the assets

of the corporation, each of which is further defined in the Notice. In addition, a corporate transaction is a permissible distribution event under Section 409A (*note*—certain key employees may be required to wait six months after a corporate transaction before they can receive a distribution).

- **Replacement Options and SARs.** Options and SARs that contain features that would cause them to be subject to Section 409A can be replaced with options and SARs respectively that do not contain such provisions. The replacement options or SARs will not be subject to Section 409A provided that (1) the cancellation and reissuance occurs on or before December 31, 2005, (2) the replacement option or SAR if it had been granted upon the original date of grant of the replaced stock option or SAR would not be subject to Section 409A, (3) the number of shares which form the basis of the new option or new SAR corresponds directly to the number of shares subject to the original option or SAR (as in the manner described in the Treasury Regulations for substitution or assumption of ISOs in a merger); and (4) the new option or new SAR does not provide any additional benefit to the service recipient (other than the benefit directly due to a change in form of the award to a form not subject to Section 409A). Also, the conversion of a SAR into an option would not cause the option to be subject to Section 409A provided the above requirements were satisfied.

**Restricted Stock.** Restricted stock that does not contain an additional deferral feature is not deferred compensation within the meaning of Section 409A.

**Restricted Stock Units.** Restricted Stock Units (“RSUs”) are subject to Section 409A but because RSUs are typically payable at a specific date, they generally do not present the type of problems that result in adverse tax consequences to the recipient under Section 409A.

**Severance Plans.** Severance plans that are either collectively bargained for or cover no key employees are not required to meet the requirements of Section 409A during 2005 provided the plan is amended by December 31, 2005 to comply with the provisions of Section 409A. Further guidance will be necessary to determine if severance payable to key employees will be outside the scope of Section 409A provided the amount is payable within a specified period of time following termination of employment.

### **Traditional Deferred Compensation Plans**

The Notice provides several points of guidance on the transitioning of traditional deferred compensation plans to comply with Section 409A.

- *Freezing or Terminating a Plan.* Amending a plan in effect as of October 3, to stop future deferrals on or before December 31, 2005 will not cause payments under the plan to be subject to Section 409A. Also, terminating a plan and distributing the amounts of deferred compensation thereunder on or before December 31, 2005 will not cause the plan or amounts distributed to be subject to Section 409A, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs.
- *Amending a Plan to Comply with Section 409A.* Plans adopted before December 31, 2005 will be treated as complying with the requirements of Section 409A during 2005 only if: (1) the plan is operated in good faith compliance with the provisions of Section 409A and the Notice during the calendar year 2005, and (2) the plan is amended on or before December 31, 2005 to conform to the provisions of Section 409A with respect to amounts subject to Section 409A.
- *Grandfathered Provisions and Material Modifications.* If an award under a plan was earned and vested as of December 31, 2004 and there has not been a material modification to that award after October 3, 2004 then the award and all subsequent earnings attributable to that award will be “grandfathered” and therefore not subject to Section 409A. In the event a material modification is made to an award after October 3, 2004 such award will lose its grandfathered status and will be subject to Section 409A even if the terms of the material modification do not violate Section 409A. Generally any addition or enhancement of a benefit to an award such as adding provisions that allow early distribution with a penalty or accelerating vesting of an award will qualify as a material modification. Amending a plan to bring it into compliance with Section 409A will not qualify as a material modification.
- *Participant Termination or Deferral Cancellation.* A plan amendment allowing plan participants to terminate their participation in the plan or cancel a deferral election any time on or prior to December 31, 2005, with respect to amounts subject to Section 409A will not cause such amounts or the plan to be subject to Section 409A

provided (1) the amendment is enacted and effective on or before December 31, 2005, and (2) the amounts subject to the termination or cancellation are includible in income of the participant in the taxable year in which the amounts are earned and vested.

- *Elections to Defer 2005 Compensation.* An election made on or before March 15, 2005 to defer compensation that relates all or in part to services performed on or before December 31, 2005 will comply with timing requirements of Section 409A, provided that (1) the individual deferring the compensation does not have a right to receive the compensation at the time of election, (2) the plan under which the deferral election is or was made was in existence on or before December 31, 2004, (3) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005 (other than a requirement to make a deferral election after March 15, 2005), (4) the plan is otherwise operated in accordance with Section 409A with respect to deferrals subject to Section 409A and (5) the plan is timely amended to comply with the requirements of Section 409A.

### **Next Steps**

- *Option and SAR awards.* Employers who have issued NSOs or SARs that will vest after December 31, 2004 should review those awards to ensure that they do not contain provisions that would require treatment of such awards as a deferral of compensation (such as an exercise price less than FMV at the date of grant, or an additional deferral feature subsequent to exercise). Also, companies that are not publicly traded should refrain from issuing SARs until additional guidance is provided with respect to their treatment under Section 409A.
- *Option Plans.* Employers should review the provisions of their option plans that govern the treatment of awards in a corporate transaction to ensure that the treatment will comply with the requirements of Section 409A. If options are being substituted or assumed in a corporate transaction care should be taken to ensure that the assumption or substitution will not result in a material modification which would make the option subject to the provisions of Section 409A.
- *Freeze Vested Plans.* If a plan only contains deferrals that will be vested prior to December 31, 2004 and were not materially modified after October 3, 2004 it should be frozen immediately to prohibit additional deferrals under

the plan and a new plan adopted that conforms to the requirements of Section 409A.

- *Termination and Amendment of Plans with Unvested Deferrals.* If a plan contains deferrals that will not be vested as of December 31, 2004 it should either be (i) terminated with all deferrals under the plan distributed by December 31, 2005 or (ii) the plan provisions applicable to all deferrals that are not fully vested as of December 31, 2004 should be amended to comply with the requirements of Section 409A by December 31, 2005. If a plan is terminated, any new plan that is adopted should contain all the necessary provisions in order to comply with Section 409A.
- *2005 Deferred Compensation.* If an employee wishes to defer compensation that relates to services performed in 2005, the employee must make an election on or before March 15, 2005 with respect to such compensation. The employee may not have a right to the compensation to be deferred at the time of the election and the election must be made pursuant to a plan that was in existence as of December 31, 2004. The plan must be operated in accordance with the requirements of Section 409A during 2005 and be amended to comply with requirements of Section 409A by December 31, 2005.

The above summary highlights certain key aspects of the Notice. The Notice contains several other points of guidance not mentioned above and is sure to be only the first of multiple publications issued by the Treasury Department on Section 409A.

If you have any questions related to this alert, please contact:

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