



FENWICK & WEST LLP

# Executive Compensation and Benefits

## 409A Action Steps to Take Prior to December 31, 2005

NOVEMBER 15, 2005

In late 2004 the IRS released Notice 2005-1 (the "Notice") which provided initial guidance on then newly enacted IRC Section 409A. Subsequently, in September of 2005 the US Treasury Department released Proposed Regulations to Section 409A of the Internal Revenue Code (the "Proposed Regulations").

Both the Notice and the Proposed Regulations provide flexibility until the end of 2006 with respect to most actions required to transition plans into compliance with Section 409A. **However, certain actions with respect to plans must be taken by the end of 2005.**

Below is a summary of the actions employers should take with respect to their plans subject to Section 409A prior to December 31, 2005.

### **1. Deferral of amounts earned and vested in 2005.**

Pursuant to the Notice, participants in deferred compensation plans were permitted to elect income deferrals for amounts that are earned and vested during 2005 later than the normal 2004 year-end cut-off date if such election was made by March 15, 2005. In order for those elections to be valid for purposes of complying with Section 409A, the plan under which the deferrals were made must be amended by December 31, 2005 to specifically validate a participant's ability to elect to make such deferrals on or prior to March 15, 2005. No action is required if participant's were not permitted to make such an election.

### **2. Deferral of amounts that will become earned and vested in 2006.**

Participants may elect to have amounts that will be earned and vested in 2006 deferred until a later year, provided the deferral election is made by December 31, 2005.

### **3. Termination of plan participation and revocation of 2005 deferrals.**

Participants can elect to terminate their participation in one or more plans subject to Section 409A or cancel previous deferral elections, in whole or in part, for amounts earned and vested in 2005 provided such elections or cancellations are made by December 31, 2005. If

such an election or cancellation is made, any deferred compensation subject to the termination of participation in the plan or canceled election must be included in the participant's 2005 taxable income.

### **4. Discounted options and SARs.**

If an employer has previously granted non-compliant stock options or stock appreciation rights (*i.e.* discounted stock options or discounted stock appreciation rights) it may increase the exercise price for such discounted stock options or stock appreciation rights that were vested as of December 31, 2004, prior to the end of 2005 in order to comply with Section 409A. In addition, to increasing the exercise price, the company may either (i) provide the holder with additional cash, stock or options that are vested upon grant if such amounts are included in increase in 2005 or (ii) provide the holder with unvested cash, stock or additional options that, in each case, vest over time, but in the latter case, to the extent the original discounted option or stock appreciation right was unvested on December 31, 2005.

If you have any questions regarding this notice please call Scott Spector at (650) 335-7251 or e-mail [sspector@fenwick.com](mailto:sspector@fenwick.com).

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