FENWICK & WEST LLP

Executive Compensation and Benefits

Taxation of Nonqualified Deferred Compensation Plans

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Congress last week passed the American Jobs Creation Act (the "Act") that is expected to be signed into law by the President. The Act provides for material changes to the manner in which nonqualified deferred compensation plans and arrangements are taxed. These changes are being implemented by the creation of a new Section 409A of the Internal Revenue Code of 1986 (the "Code") and by guidance from the United States Treasury Department.

The material provisions of the Act relating to deferred compensation are as follows:

- ***Arrangements Implicated.*** Nonqualified deferred compensation includes any plan, arrangement or agreement that provides for the deferral of compensation, other than pursuant to a qualified employer plan (*e.g.*, an employer's 401(k)) or any bona fide vacation, leave, sick leave, compensatory time, disability pay or death benefit plan.

  The Act will also apply to certain traditional forms of equity compensation, but will not apply to stock options granted at 100% of fair market value (so long as such options do not contain elective deferral of income features). Restricted stock that provides for deferral after vesting, restricted stock units where employees control the payment date, discount stock options and stock appreciation rights will fall within Section 409A.

- ***Requirements.*** The Act imposes rigid requirements that must be followed in order for amounts payable under deferred compensation plans or arrangements to be eligible for tax-deferred treatment. These include:

  - Permitted Distributions. Distributions of amounts deferred cannot be distributed before: (i) a participant's separation from service (with an additional six month delay for individuals who qualify as key employees); (ii) a participant's disability or death; (iii) a specified time or under a fixed schedule specified under the arrangement as of the date of deferral; (iv) a change in control (to the extent permitted by the Internal Revenue Service) or (v) upon an unforeseeable emergency.

  - No Acceleration. The plan or arrangement may not provide for the acceleration of the time or schedule of any payment, except as provided by regulations issued by the Internal Revenue Service.

  - Initial Elections to Defer. An initial election to defer compensation must be made no later than the close of the taxable year prior to the taxable year to which the election relates (however, in the first year in which an employee becomes eligible for participation, the election can be made within 30 days after the date the employee is initially eligible). Also, the time (when distributions will commence) and form (lump-sum or installments) of distribution must be specified at the time of the initial deferral.

  - Subsequent Elections. A subsequent election to delay the timing or form of distribution is permitted only if (i) such election is not effective for at least 12 months after the date of election; (ii) the additional deferral with respect to which such election is made is for a period not less than five years from the date such payment would otherwise have been made (except for elections relating to distributions on account of death, disability or unforeseeable emergency); and (iii) an election related to a distribution to be made upon a specified time (or pursuant to a fixed schedule) may not be made less than 12 months prior to the date of the first scheduled payment.
  - Key employees are generally defined as (i) officers having annual compensation greater than $130,000

(limited to 50 employees); (ii) 5% owners and (iii) 1% owners having annual compensation from the employer greater than $150,000.

- An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent; or loss of the participant's property due to unforeseeable circumstances arising as a result of events beyond the control of the participant.

- Certain Rabbi Trusts Not Allowed. Rabbi trusts are generally still permitted. However, the use of a "springing" rabbi trust (*e.g.*, one that is funded when a triggering event such as the financial deterioration of the sponsoring employer occurs) will not be permitted. If a plan provides for the use of such a "springing" rabbi trust, the plan will be taxable as of the date that a plan or arrangement includes such a provision.

- ***Equity Arrangements.*** As noted above, given the broad definition of deferred compensation, companies should be mindful of the types of equity awards that will fall within Section 409A and require careful analysis of problematic issues. In particular, discount stock options and stock appreciation rights will be adversely impacted by Section 409A.

- ***Penalties.*** If the specific statutory requirements of Section 409A are not satisfied with respect to any participant, then the amount of compensation deferred under the plan or arrangement by the participant will be taxable in the year of vesting, with interest from such date, and will be subject to a 20% excise tax.

- ***Effective Dates.*** The Act is effective for amounts deferred in taxable years beginning after December 31, 2004. An amount will be deemed to have been deferred before January 1, 2005 provided such amount was earned and vested before such date. Amounts deferred in taxable years before January 1, 2005 will not be subject to Section 409A, provided that the plan or arrangement pursuant to which the deferral was made is entered into prior to October 3, 2004 and is not materially modified after October 3, 2004. A material modification is generally defined to mean the addition of a benefit or right (for instance amending a plan to provide for acceleration of vesting upon certain enumerated events). A reduction of a benefit or right or the exercise of a pre-existing right under a plan (for instance, where the plan currently permits participants to change an election from installments to a lump-sum payment) generally will not be considered a material modification.

- ***Transition Guidance.*** Within 60 days of enactment of the Act, the Internal Revenue Service is required to issue guidance that provides a period of time during which a plan or arrangement adopted prior to December 31, 2004 may, without violating the requirements of Section 409A, be amended to provide that a participant may terminate participation in the plan or arrangement or to cancel an outstanding election or to conform such arrangements to the new rules of Section 409A.

Open Issues

The following issues will need to be resolved by the Transition Guidance.

- What is a discount stock option? Will the treasury regulations provide for a good faith standard as is applied in the case of incentive stock options? If not, private companies could run afoul of the new rules and be considered to be issuing options at a discount if a "cheap stock" charge is taken or is required by a regulatory agency such as the Securities Exchange Commission.

- Does acceleration of vesting or extension of the time an option may be exercised after the effective date result in a "modification" such that the acceleration or extension would be treated as a grant of a new option at a discount?

- Does performance acceleration of restricted stock or restricted stock units cause the award to be treated as failing to satisfy Section 409A?

Next Steps

Existing Nonqualified Deferred Compensation Plans.

For employers who sponsor a nonqualified deferred compensation plan or arrangement, consideration should be given to freezing the plan with respect to amounts that are earned and vested as of December 31, 2004. The same employer should consider adopting a new nonqualified deferred compensation plan that is drafted to specifically comply with Section 409A. Doing so should protect the "older plan" and its assets from becoming disqualified or tainted.

Equity Awards. Employers should carefully review their outstanding equity awards other than options issued at fair market value to determine which awards are unvested as of December 31, 2004, and take actions to minimize the potentially adverse tax effects that arise with respect to awards that vest after December 31, 2004.

Amounts Deferred in 2004. Deferrals for 2004 should be scrutinized to ensure that amounts deferred are earned and vested before January 1, 2005.

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

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