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IRC Section 409A Update
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IRS Provides Updated Proposed Regulations Relating to Deferred Compensation and Stock Appreciation Rights

On 9/29/05 the IRS issued a 238 page update to Section 409A, part of the Job Creation Act signed by President Bush in October 2004. Section 409A covers nonqualified deferred compensation plans and a number of other compensation arrangements. It imposes a number rules that these plans must follow for participants to avoid immediate taxation, an additional 20% penalty tax, and interest on underpayments of tax. If you have trouble sleeping, you can read the regulations at http://www.treas.gov/press/releases/reports/reg15808004.pdf.

Timing

Public hearings are scheduled for early 2006 and final regulations will be issued by 1/1/07. Employers and "service providers" (employees, outside consultants and directors) are required to be in compliance with the proposed rules of §409A until final rules are issued, although deadlines for compliance have been extended until 12/31/06.

All existing plans must be changed by 12/31/06 to comply with §409A. The deadline for participant elections relating to the post-2006 distributions has been extended to December 31, 2006. However, an employer's ability to terminate a NQDC plan and make a total distribution of all benefits accrued under it, without regard to the provisions of §409A, remains subject to the existing deadline of December 31, 2005. Furthermore, the December 31, 2005 deadline for a participant to terminate existing deferral elections with regard to amounts that would be subject to §409A has not been extended. As a result, some participants may need to take action before the end of 2005. Similarly, if a plan document needs to be amended to reflect this termination right, the amendment also must be in place by December 31, 2005.

Severance Arrangements. Most severance arrangements, including early retirement windows, are exempt from §409A, provided that: (1) the amount of severance paid is less than $210,000 (as indexed) or two times the service provider's annual compensation, and (2) all payments are made by the end of the second calendar year following the year the service provider leaves. There are, however, additional rules that apply to severance arrangements that fail to qualify under the above test. Separation payments made to key employees of public companies must be delayed 6 months from the date of separation (unless caused by death or disability).

Discount Stock Options. While most stock options (both incentive and nonqualified) are exempt from §409A, the proposed regulations will apply to an option that has an exercise price less than the market value of the stock (discount options) or that permits the deferral of income beyond the option's exercise or vesting. The proposed regulations extend until 12/31/05 the deadline to replace discount stock options and SARs (stock appreciation rights) that were not fully vested as of 12/31/04. The replacement cannot result in the cancellation of an option or SAR in exchange for cash or vested stock (or other property) in 2006; such exchange can only take place in 2005. The exercise of a discounted option or SARs in 2005 is treated as a permissible cancellation of a deferral of compensation.

Stock Appreciation Rights ("SARs"). One area in which the proposed regulations deviate significantly from prior guidance relates to SARs. The proposed regulations exempt SARs issued by both public and private companies from the requirements of §409A if the SARs are settled in stock or in cash. However, the valuation rules described above for stock options also apply. Since options and SARs must both be granted at fair value, the value assigned non-publicly traded stock is critical. The §409A lists a number of rules that need to be considered as to whether a valuation methodology is reasonable. Independent appraisals used to determine values for an ESOP are acceptable. Other approaches are not as clear and there may be valuation issues for employers that are not publicly traded. For example, a private company granting SARs based on book value may not meet the fair-value requirement and exemption from §409A. The rules state that the same valuation methodology must be reasonable and consistently used for all stock transactions. The rules suggest start-up corporations with highly speculative illiquid stock use an outside written appraisal. The issue of valuation is critical because stock granted at a discount to fair value will be considered deferred compensation and thus regulated by §409A.

IRC §457(f) Programs for Tax-Exempt Employers. The proposed regulations clarify that IRC §457(f) NQDC arrangements sponsored for executives of tax-exempt employers must apply the §409A guidance separately from regulations under IRC §457(f).

Rules That Relate to Deferral Elections

A decision to defer 2006 compensation must be made in 2005, unless it is performance based pay, when a participant may make an initial deferral election no later than 6 months before the end of a performance period. The performance period must be at least 12-months in duration.

Definition of Performance-Based Pay. The proposed regulations define performance-based pay as compensation that is contingent on the satisfaction of pre-established organizational or individual performance criteria that may be established up to 90 days after the commencement of the period of service to which the criteria relates. It may also be based on subjective performance criteria and, in a change from previous guidance, may be based solely on an increase in the value of the employer’s stock after the beginning of the performance period.

Short-Term Deferrals. Generally, a payment will not be classified as deferred compensation if it is paid within 2½ months after the services are rendered and the amount is vested. If a payment date that meets the 2½-month rule is specified in an agreement, a deferred payment may be made in the same calendar year as the fixed payment date, thereby avoiding penalties. If no payment date is specified, a deferred payment will result in a violation of §409A, and penalties will apply.

Distribution Issues

Selection of Payment Dates. Payments must be made at a fixed date, under a fixed schedule, or on any of five enumerated events. A payment is treated as made on the designated date if the payment is made by the later of the first date that it is administratively feasible or the end of the calendar year containing the designated date.

Links with Qualified Plan Payments. The regulations also extend through 2006 the ability of a NQDC plan to link the form and timing of payments to those elected under a correlative qualified plan. In other words, where a NQDC plan wraps around a qualified §401(k) plan, the NQDC plan may continue to provide that the form and timing of distributions under it will be the same as those elected under the §401(k) plan.

Treatment of Stream of Payments. Under §409A, a designated payment date for NQDC may be further deferred only: (a) on 12 months prior notice, and (b) if the payment is deferred for at least 5 years. This raised issues with respect to NQDC arrangements that contemplate a stream of payments over several years, leaving uncertain whether these are treated as separate payments or as one payment. However, the proposed regulations provide that the NQDC arrangement may specify whether the installments are one payment or separate payments.

Permitted Payment Delays. The proposed regulations describe several circumstances in which payments of NQDC may be delayed, where initiated by the employer.

Accelerated Payment on §409A Violation. §409A prohibits the acceleration of the time or schedule of a payment from a NQDC plan. However, under the proposed regulations, a plan may permit the acceleration of the time or period of payments in order to pay: (1) the amount that the service provider must include in income as a result of the plan's failure to meet the requirements of §409A; (2) a domestic relations order; (3) employment taxes; and/or (4) specified de minimis amounts.

Plan Termination Rules. Because the termination of a deferred compensation plan invariably accelerates the dates on which accruals would otherwise be distributed, plan terminations could lead to a violation of §409A, thereby imposing retroactive penalties on the service provider. While the Treasury Department is considering further guidance in this area, the proposed regulations provide several circumstances in which a plan termination may accelerate distributions. However, in the absence of a significant event involving the employer (such as a change in control), the employer may avoid a §409A violation only if it does not adopt a new plan similar to the terminated plan for 5 years.

Fiscal Year Employers. If the employer's fiscal year is other than the calendar year, elections to defer compensation (other than salary) that is based on the employer's fiscal year may be made prior to the beginning of the fiscal year. Otherwise, the deferral election must be made prior to the beginning of the calendar year in which the fiscal year starts.

<u>Material Modifications</u>

Rescission of Changes That Lead to Material Modification. Generally, a material modification to a grandfathered NQDC plan will result in the imposition of coverage under §409A. In a positive development, the proposed regulations provide that a material modification may be rescinded before (1) the earlier of the date that any additional right granted under the modification is exercised, or (2) the end of the calendar year in which the modification is made.

Investment Changes. A change in the investment opportunities relating to a deferred compensation arrangement will not be a material modification.

In Closing

Employers must pay close attention to 409A and its impact on deferred compensation plans and SARs. Failure to comply with 409A rules will result in significant penalties to the company and the participant. Detailed questions related to specific 409A programs should be directed to your legal counsel.

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