

January 2005

IRS Guidance for Deferred Compensation Plans — Stage 1

An Overview of IRS Notice 2005-1

On December 20, 2004, the IRS issued Notice 2005-1, which provides the first interim guidance on the new limits for deferred compensation plans in Internal Revenue Code Section 409A, which was enacted by the American Jobs Creation Act (the “Act”). For a summary of Code Section 409A itself, click here for our recent *Management Alert*.*

Under the Act, Congress instructed the IRS to issue transitional guidance within 60 days of enactment to help companies comply with these new rules, which generally takes effect on January 1, 2005. Notice 2005-1 provides helpful guidance for complying with many aspects of the Act, including the following:

- ◆ Employees may make deferral elections for 2005 compensation, or change elections previously made, up until March 15, 2005, as long as the plan was in existence on December 31, 2004.
- ◆ No plan document amendments are required to be made until December 31, 2005, although plans must be administered in accordance with the new rules during 2005.
- ◆ Employees may elect to change their form of payment for benefits that have already been earned at any time during 2005. (However, this may cause benefits earned prior to 2005 to lose their grandfathered status).
- ◆ Compensation deferrals may be revoked entirely at any time during 2005 without adverse tax consequences, either unilaterally by the company (subject to any contractual obligations) or at the employee’s election.
- ◆ Amounts that are paid within 2½ months after the year in which they are vested, such as stay bonuses and some types of severance, are not deferred compensation under the Act.

However, the Notice does not address the rules for determining key employees for purposes of the six-month delay for distributions made by public companies on account of separation of service; the effects (if any) of the Act on paid-time off (PTO) arrangements; and various other compliance issues under the Act. The IRS is expected to address additional compliance issues in 2005.

Effective Dates and Transition Rules

Effective Date. The requirements of Code Section 409A became effective January 1, 2005 for deferrals of compensation on or after

that date. However, pre-2005 deferrals may also be covered under the Act if the plan to which such deferrals relate has been or is materially modified after October 3, 2004, or if the pre-2005 deferrals are not vested as of December 31, 2004.

Grandfathered Amounts. Amounts deferred and vested prior to December 31, 2004 can be (but are not required to be) “grandfathered” under the Act. This means that such amounts can continue to subject to the deferred compensation rules in effect prior to the Act, unless the plan has been or is “materially” modified after October 3, 2004. Under the Notice, an amendment is “material” if it accelerates vesting or adds a new benefit or form of payment, but not if the plan is merely amended to comply with the Act. It is not a material modification for either an employer or participant to exercise an option that existed under the plan on October 3, 2004.

New Deferrals. For post-2004 deferrals, until Treasury issues additional guidance, deferred compensation plans will be deemed to satisfy the requirements of Code Section 409A if they are administered in accordance with the Notice and in accordance with a good-faith interpretation of the Act. No formal plan amendments are required until December 31, 2005. However, public companies should consider any applicable shareholder approval requirements, and may wish to make their plan amendments earlier in order to submit them for approval at the 2005 shareholder meeting.

2005 Deferral Elections. If a deferred compensation plan was in existence as of December 31, 2004, a participant may make an election to defer compensation for services rendered in 2005 as late as March 15, 2005, for compensation payable after the election. This rule also applies to bonuses that were earned in 2004, but are not yet vested. Employers who required participants to make 2005 deferral elections prior to December 31, 2004, may, but are not required to, allow employees to revise their elections until March 15.

Revocation of Previous Deferral Elections. A plan adopted before December 31, 2004 may permit compensation deferrals to be revoked at any time prior to December 31, 2005. This provision allows deferred compensation arrangements to be unwound without adverse tax consequences during 2005, although the amount deferred will be taxable income to the individual.

* The *Management Alert* is also available on our website at www.seyfarth.com/db30/cgi-bin/pubs/102204.pdf.

New Distribution Elections. A plan may be amended to permit employees to make new distribution elections by December 31, 2005. However, if the amendment applies to amounts that were deferred prior to 2005, such amounts will no longer be grandfathered.

Covered Deferred Compensation

The Notice clarifies the definition of “deferred compensation” subject to the Act. Generally, any amount a person has a legally binding right to receive in one year that will be paid in a subsequent year is “deferred compensation” under the Act. However, if an amount is paid within 2½ months after the end of the taxable year in which the individual becomes vested, it is not considered deferred compensation subject to Code Section 409A. Thus, severance plans and retention bonus arrangements will generally not be subject to the Code Section 409A if they do not provide for further deferral after payments become vested and payments are made within the 2½ months after the later of the individual’s tax year or the employer’s tax year.

Equity-Based Arrangements

ISOs and ESPPs. Incentive stock options issued under Code Section 422 and employee stock purchase plans that satisfy the requirements under Code Section 423 are not considered deferred compensation plans under the Act.

Non-Statutory Stock Options. Nonstatutory stock options are generally not subject to Code Section 409A unless: (1) the option is granted at a discount from fair market value, or (2) the option includes other income deferral features, such as a right to convert the option to a form of deferred compensation.

SARs. In general, SARs are subject to Code Section 409A. However, an SAR will not be treated as deferred compensation if: (1) the SAR threshold is not less than the fair market value of the underlying stock on the date the right is granted; (2) the stock of the employer is traded on an established securities market; (3) the stock appreciation right may only be paid in employer stock; and (4) the stock appreciation right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. Under a special grandfather rule, SARs issued under a plan in place on October 3, 2004, are also exempt even if they are issued by a private company or settled in cash, as long as they satisfy the other requirements above.

The notice also explains that an SAR that is treated as deferred compensation may be structured to comply with Code Section 409A even if the holder has the right to exercise the SAR at any time, as long as the actual payment date is based on one of the permissible payment events under Code Section 409A, such as termination of employment, a specified date, or a change of control.

Restricted Stock. The Notice clarifies that the receipt of restricted stock will not be treated as a deferral of compensation under Code Section 409A simply because the value of the property is not includible in income until the stock is vested.

Other Clarifications

De Minimis Cash-Outs. A deferred compensation plan may provide for a de minimis cash-out payment of up to \$10,000.

Non-Acceleration. Applying deferred compensation to comply with the terms of a domestic relations order or to pay FICA taxes is not treated as a prohibited acceleration of benefits.

Reporting and Withholding Requirements. The Notice indicates that the IRS will issue additional guidance on reporting and withholding on deferred compensation. For purposes of withholding during 2005, deferred compensation that is includible in gross income during the 2005 calendar year under Code Section 409A (but which has not been actually or constructively received) may be treated as paid on any day on or before December 31, 2005.

If you have any questions concerning this Management Alert, please contact the Seyfarth Shaw LLP Employee Benefits Group attorney with whom you work or any Employee Benefits attorney on the website at www.seyfarth.com.

This newsletter is a periodical publication of Seyfarth Shaw LLP and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. For further information about these contents, please contact the firm’s Employee Benefits Practice Group.

ATLANTA

One Peachtree Pointe
1545 Peachtree Street, N.E., Suite 700
Atlanta, Georgia 30309-2401
404-885-1500
404-892-7056 fax

BOSTON

Two Seaport Lane, Suite 300
Boston, Massachusetts 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO

55 East Monroe Street, Suite 4200
Chicago, Illinois 60603-5803
312-346-8000
312-269-8869 fax

HOUSTON

700 Louisiana Street, Suite 3700
Houston, Texas 77002-2797
713-225-2300
713-225-2340 fax

LOS ANGELES

One Century Plaza
2029 Century Park East, Suite 3300
Los Angeles, California 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK

1270 Avenue of the Americas, Suite 2500
New York, New York 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO

400 Capitol Mall, Suite 2350
Sacramento, California 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO

560 Mission Street, Suite 3100
San Francisco, California 94105
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.

815 Connecticut Avenue, N.W., Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS

Boulevard du Souverain 280
1160 Brussels, Belgium
(32)(2)647.60.25
(32)(2)640.70.71 fax