

Employee Benefit Update

August 2005

It's Time to Establish a Deferred Compensation Action Plan

Section 409A was added to the Internal Revenue Code by the American Jobs Creation Act of 2004, and is generally effective as of January 1, 2005. Section 409A adds a number of complex new rules for nonqualified deferred compensation plans, and imposes severe tax penalties for noncompliance. These new rules were summarized in our November 2004 Employee Benefits Update. Following that update, the Internal Revenue Service ("IRS") issued Notice 2005-1, providing limited guidance on Section 409A. The IRS anticipates issuing additional guidance later this year. In the interim, in view of the December 31, 2005 deadline for amending plans and arrangements to comply with Section 409A, employers should prepare

now to act quickly when the additional guidance is issued.

IRS Guidance to Date

- "Deferred Compensation Plan" is defined broadly. Section 409A applies to plans and arrangements not traditionally thought of as deferred compensation plans. Stock options, phantom stock, restricted stock units, stock appreciation rights, employment agreements, severance plans, bonus plans, incentive plans, separation agreements, and layoff plans all may be "deferred compensation plans" within the scope of Section 409A.
- December 31, 2005 deadline. Employers must amend their deferred compensation plans and

arrangements to comply with Section 409A by December 31, 2005.

- Transition rules for 2005. Notice 2005-1 offers transition relief to employers with plans and arrangements subject to Section 409A. Employers must affirmatively take advantage of these transition rules before December 31, 2005.

Action Steps

Less than six months remain until the December 31, 2005 deadline for amending plans and arrangements. Employers thus need to act now to:

- Identify existing deferred compensation plans and arrangements.
- Review these plans and arrange-

SHEPPARD, MULLIN, RICHTER & HAMPTON LLP

LOS ANGELES
(213) 620-1780

CENTURY CITY
(310) 228-3700

SAN FRANCISCO
(415) 434-9100

ORANGE COUNTY
(714) 513-5100

DEL MAR HEIGHTS
(858) 720-8900

SAN DIEGO
(619) 338-6500

SANTA BARBARA
(805) 568-1151

NEW YORK
(212) 332-3800

WASHINGTON, D.C.
(202) 218-0000

ments for provisions requiring changes to comply with Section 409A.

- Consider whether to take advantage of the transition rules provided under Notice 2005-1.
- Amend or terminate these plans and arrangements to comply with Section 409A, obtaining any necessary corporate approval.
- If terminated, all amounts deferred under the plan or arrangement must be distributed and included in participant income in 2005.
- Employers should generally postpone amendments to conform with Section 409A until the IRS issues the anticipated additional guidance. This is particularly important since amounts deferred and vested before January 1, 2005 could lose their grandfather status if the plan is materially modified.
- Communicate and implement the adopted changes and transition relief.

The foregoing is merely a summary of the action steps that should be undertaken in response to Section 409A. Please contact our benefits attorneys so we can assist you with the process of bringing your deferred compensation plans and arrangements into compliance with Section 409A.

If you have questions regarding Employee Benefits issues, please contact one of our Employee Benefits attorneys:

- John R. Bonn..... (978) 594-0170
- Michael Chan..... (213) 617-5537
- Michael Gerald (213) 617-4183
- David J. Paik..... (213) 617-4196
- D. Matthew Richardson..... (213) 617-4222
- Martin J. Smith (213) 617-5490

Applicability of the legal principles discussed may differ substantially in individual situations. The information contained herein should not be construed as individual legal advice.

certain key employees as defined under the Code may not receive a distribution by reason of separation from service for at least six months after the separation.

ELECTION RULES. A participant must make a deferral election in the taxable year before the taxable year in which the compensation will be earned, except in the case of a participant who first becomes eligible to participate in a plan. Such a participant will have 30 days after the date he or she becomes eligible to make the deferral election.

BENEFIT ACCELERATION. The Act provides that a plan may not permit the acceleration of the time any payment under the plan is to be made, unless otherwise provided in regulations. This provision will prevent the common acceleration technique referred to as a "haircut."

FUNDING ARRANGEMENTS. The Act limits two common funding approaches. First, the use of offshore rabbi trusts is generally prevented. Second, so-called "trigger" or "springing" plans, which provide that assets become restricted to providing benefits to participants in the event of a change in the employer's financial condition or net worth, are also limited.

INCOME INCLUSION AND PENALTIES. If a plan or arrangement fails to meet the above requirements, all compensation deferred will be included in the participant's gross income. This includes the current years' deferrals, as well as all preceding year's deferrals. In addition, a penalty of 20% of the includable compensation is added, as well as interest at the underpayment rate under the Code plus 1%, on the additional tax.

REPORTING RULES. The Act requires that amounts includable in income be subject to withholding by the employer. In addition, total amounts deferred for a year are required to be reported on Form W-2 or Form 1099, as applicable, even if such amounts are not includable in income for that year.

EFFECTIVE DATE. The Act applies to amounts deferred or vested after December 31, 2004. Subject to this rule, existing arrangements would not be covered unless they are materially modified after October 3, 2004. Accordingly, it is extremely important not to amend an existing plan or arrangement until the Act's implications regarding the amendment are carefully analyzed.

ACTION STEPS. Because of the short timeframe involved, employers should act now to:

- Identify existing plans and arrangements;
- Establish an action plan;
- Develop employee communication and consent strategy;
- Evaluate securities law disclosures for public companies;
- Amend or freeze plans and arrangements and obtain board approval where needed; and
- Revise service agreements with vendors.

The foregoing is merely a summary of the complex provisions of the Act. Please contact our benefits attorneys so we can assist you with the process of bringing your deferred compensation plans and arrangements into compliance with the Act.

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DISCLAIMER

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