

# Employee Benefit Update

December 2005

## Deferred Compensation: Section 409A Action Steps for 2005

On September 29, 2005, the IRS issued proposed regulations under Section 409A of the Internal Revenue Code. These proposed regulations generally expand upon existing guidance, and in some ways interpret Section 409A more favorably for taxpayers than previous guidance. Companies must comply in good faith with Section 409A during 2005 and 2006. For example, payments made before the end of 2006 must comply. Employers may rely on the proposed regulations to demonstrate good faith compliance for 2005 and 2006. The proposed regulations generally extend the deadline for amending arrangements to comply with Section 409A until December 31, 2006. Certain actions, however, must be completed before the end of 2005.

### Section 409A Background

Section 409A contains complex new

rules for nonqualified deferred compensation arrangements, which we summarized in our November 2004 Employee Benefits Update, and imposes severe tax penalties for noncompliance. Prior to the proposed regulations, the IRS provided partial guidance at the end of 2004. The scope of Section 409A is broad, and includes stock options, phantom stock, restricted stock units, stock appreciation rights, employment agreements, severance plans, bonus plans, incentive plans, separation agreements, and layoff plans. As we have previously advised, companies should review their deferred compensation arrangements to identify those subject to Section 409A. If you believe that you may have a compliance issue under Section 409A, or if you plan to implement any new plan or arrangement, you should consult with a member of our Employee Benefits group.

### Actions to be Completed by December 31, 2005

Less than one month remains until the December 31, 2005 deadline to:

- Terminate grandfathered arrangements and distribute all benefits to participants.
- Cancel or revoke an outstanding deferral election, or terminate participation in an arrangement, and amend the arrangement. The amount must be included in the participant's income in the later of 2005 or the year in which they vest.
- Compensate an optionee in cash for the lost discount on replaced stock options.
- Elect to defer compensation earned in 2006.
- Change payment elections for amounts scheduled to be paid in 2006, or accelerate payments to 2006.

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- Amend arrangements to reflect provision for participant elections to defer 2005 compensation that were made between December 31, 2004 and March 15, 2005 (or until June 30, 2005 for performance-based compensation), as permitted under earlier guidance.

Employers should be careful not to materially modify grandfathered plans, since this may eliminate their grandfathered status. Companies should also evaluate their process for setting the exercise price of stock options, which may not be less than the fair market value of the company's stock on the date granted. Fair market value for a public company is determined based on reported transactions. A private company must determine stock value by the consistent reasonable application of a reasonable valuation method, taking relevant factors into consideration. The proposed regulations provide three methods for private companies that generally will be presumed reasonable.

**Actions Steps for 2006**

For 2006, companies must:

- Report and withhold amounts subject to Section 409A, beginning with 2005 deferrals.
- Amend deferred compensation arrangements to comply with Section 409A by December 31, 2006

(arrangements must be operated in good faith compliance in 2005 and 2006).

- Replace outstanding stock rights to avoid Section 409A by December 31, 2006, such as replacing discounted stock options with undiscounted options.
- Change participant payment elections for amounts payable in 2007 or later without having to comply with Section 409A until December 31, 2006 (but payments cannot be accelerated to 2006).

Because of possible limits on amending arrangements, we recommend that companies act to amend arrangements and replace outstanding stock rights as soon as possible and in any event by the end of the second quarter of 2006. In addition, publicly-traded companies generally may need to report material amendments to deferred compensation plans.

The proposed regulations, though extensive, do not address all of the issues that arise under Section 409A, some of which are specifically left for future guidance.

The foregoing is merely a summary of the action steps that should be undertaken in response to the proposed regulations under 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:

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