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Transition Relief Under the New Nonqualified Deferred Compensation Proposed Regulations

On September 29, 2005, the Internal Revenue Service issued proposed regulations on the new deferred compensation law (section 409A of the Internal Revenue Code). These regulations expand upon the guidance in Notice 2005-1, although the notice remains in effect to the extent it does not conflict with the proposed regulations. Background on Code section 409A and Notice 2005-1 is in Nonqualified Deferred Compensation Plans: IRS Issues Transitional Relief, a previous e-alert that focuses on the transition rules.

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Deferrals Affected by Code Section 409A

Generally, all amounts and income thereon deferred after December 31, 2004 are subject to Code section 409A. Conversely, amounts and income thereon deferred prior to January 1, 2005 are generally not subject to Code section 409A (i.e., "grandfathered") unless the plan is "materially modified" after October 3, 2004. A material modification is a change to an amount earned and vested prior to January 1, 2005 that enhances benefits or rights under a plan existing as of October 3, 2004, or adds new benefits or rights to a plan.

Expired Deadlines

Initial Elections to Defer 2005 Compensation. Deferral elections must be made prior to the year the compensation is earned. For 2005, however, the IRS permitted deferral elections up to March 15, 2005 for plans in place prior to December 31, 2004. This relief was not extended.

Actions Which Must Be Taken by December 31, 2005

Initial Elections to Defer 2006 Compensation. The deadline for an election to defer 2006 compensation expires on December 31, 2005.

Cancellation of Deferral Elections or Termination of Participation in a Plan. The deadline for plan participants to cancel deferral elections or terminate their participation in a plan (and for plan administrators to amend plans to permit such elections) expires December 31, 2005. Amounts subject to the cancellation or termination must be included in the participant's income in 2005, or, if later, the

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first year such amounts are earned and vested.

Such cancellations or terminations are treated as effective as of January 1, 2005, and may apply in whole or in part to one or more plans, and to one or more outstanding deferral elections. Similarly, the exercise of stock options, stock appreciation rights ("SARs") or similar equity compensation subject to 409A prior to December 31, 2005 will be treated as a cancellation of such arrangement.

If an amendment permits a participant to choose between terminating their participation or continuing in a grandfathered plan, the plan loses its grandfathered status (i.e., all amounts deferred under the plan with respect to that participant become subject to Code section 409A). Therefore, plan administrators preferring to terminate a plan altogether rather than lose grandfathered status should exclude any option to continue participation from plan amendments.

Plan Terminations. The deadline for plan administrators to terminate a plan and distribute deferred amounts expires December 31, 2005. All deferred compensation must be distributed and included in income in the year of termination. Plan administrators may terminate a particular plan without affecting other plans of the same type (e.g., account balance plans, non-account balance plans, separation pay arrangements, etc.), as the aggregation rules do not apply to plan terminations.

Actions Which Must Be Taken by December 31, 2006

Plan Amendments to Conform to Code Section 409A. The deadline to amend a plan to comply with or to come within an exception to Code section 409A has been extended to December 31, 2006. Until amended, plans must be operated in good faith compliance with the requirements of Code section 409A and Notice 2005-1. Accordingly, the requirement of a six month delay for distributions upon separation from service to key employees of public companies currently applies to all amounts subject to Code section 409A. Compliance with the proposed regulations is considered good faith compliance with Code section 409A.

Participant Elections to Change the Time and Form of Payments. The deadline for plan participants to elect to change the time and form of payments under plans subject to Code section 409A (and for plan administrators to amend plans to permit such elections) has been extended to December 31, 2006. Such elections and amendments may not apply to amounts otherwise payable in 2006 or cause amounts to be paid in 2006 that would not otherwise be payable in 2006. The

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deadline to amend stock options and stock appreciation rights subject to Code section 409A to provide for fixed payment terms consistent with 409A, or permit elections for such terms, has been extended to December 31, 2006. Elections in effect as of October 3, 2004 that link the time and form of payments for plans subject to Code section 409A to qualified plans (e.g., retirement plans qualified under Code section 401(a)) will not violate Code section 409A until January 1, 2007.

Substitutions of Discounted Stock Options and SARs with Non-Discounted Stock Options and SARs. The deadline to cancel and replace discounted stock options and SARs with non-discounted stock options and SARs has been extended to December 31, 2006. The exercise, however, of discounted stock options or SARs in 2006 prior to cancellation and replacement will violate Code section 409A. Where the fair market value of the underlying stock has decreased to or below the original exercise price, cancellation and replacement may offer the psychological benefit of not changing the participant's exercise price.

The IRS has noted three ways to compensate participants for the loss of the discount attendant to the cancellation and replacement:

1. cash payments, so long as made prior to January 1, 2006;
2. restricted stock with a fair market value equivalent to the lost discount, and with a vesting schedule parallel to that of the substituted option or SAR; and
3. a separate plan promising payment of the lost discount (plus earnings) with a vesting schedule parallel to that of the substituted option or SAR.

An alert addressing the substantive effects of the proposed regulations (e.g., the new rules for severance arrangements, the expanded exception for certain SARs, etc.) is forthcoming. For additional information on Code section 409A compliance, please contact one of the members of our Executive Compensation Team.

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