

Client Alert

Latham & Watkins Tax Department

Proposed Regulations under Section 409A of the Internal Revenue Code Require Actions during 2005

This is one in a series of Client Alerts that the Latham & Watkins Benefits and Compensation Group will be issuing on the recent proposed regulations under Section 409A of the Internal Revenue Code regarding non-qualified deferred compensation.¹

This Client Alert focuses on the actions that employers must take by December 31, 2005 to comply with Section 409A and benefit from the available transition rules under Internal Revenue Service Notice 2005-1 and the proposed regulations.

Last month, the Treasury Department released proposed regulations under Section 409A of the Internal Revenue Code. Section 409A made significant changes to the tax rules applicable to non-qualified deferred compensation (NQDC). The Treasury Department previously issued transition guidance under Notice 2005-1. The proposed regulations modify the transition rules under Notice 2005-1.

Many of the Section 409A transition rules under Notice 2005-1 have been extended by the proposed regulations. However, certain transition rules have not been extended. The following issues require that employers take certain actions *no later than December 31, 2005*:

- *Opportunity to Terminate Participation or Cancel Deferrals under NQDC Plans.* An NQDC plan may be amended during 2005 to provide for termination of participation or cancellation of deferrals under the plan, and the distribution of deferred compensation subject to Section 409A. The deferred compensation must be distributed by December 31, 2005 (or, if later, during the taxable year in which the deferred compensation is “earned and vested,” as defined in the proposed regulations).

The distribution of the deferred compensation under this transition rule will not cause the NQDC plan to fail to comply with Section 409A. The termination or cancellation may apply to some or all of the employees participating in a NQDC plan, and may apply to all or a portion of an employee’s deferred compensation under the NQDC plan. The termination or cancellation may be made at the employer’s election or the employee’s election, and relief is provided from the constructive receipt doctrine (which normally would limit the use of employee elections).

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This transition rule was not extended beyond December 31, 2005. Any amendments that are necessary to provide for the termination of participation or cancellation of deferrals, and the distributions of deferred compensation, must be adopted and effective by December 31, 2005.

- *Opportunity to Terminate and Distribute “Grandfathered” NQDC Arrangements.* Deferred compensation under an NQDC arrangement that was deferred and “earned and vested” on or before December 31, 2004 (a “grandfathered” arrangement), is not subject to Section 409A, unless the arrangement is “materially modified” (as defined in the proposed regulations) after October 3, 2004. A “grandfathered” NQDC arrangement may be terminated and distributed in full by December 31, 2005 without violating Section 409A.

The termination and full distribution of the “grandfathered” arrangement will not be a “material modification.” However, an amendment to a “grandfathered” NQDC arrangement permitting termination or cancellation, at the employee’s election, will be a “material modification.” If an employee does not elect a termination or cancellation, or elects only a partial cancellation of the arrangement, the amendment will subject any deferred compensation that is not distributed upon termination or cancellation to Section 409A.

- *Exercise or Terminate Stock Option and Stock Appreciation Right (SAR) Awards.* Stock option and SAR awards that were granted with a fair market value exercise price at grant generally are not subject to Section 409A. Stock option and SARs awards that were granted with an exercise

price that was less than the fair market value of the stock at grant (discounted awards) are subject to Section 409A, unless such awards are “grandfathered.” Discounted stock option and SAR awards will require significant changes in order to comply with Section 409A.

Discounted stock option and SAR awards subject to Section 409A may be exercised or cancelled by December 31, 2005 and avoid the application of Section 409A under a transition rule. Also, stock option and SAR awards that have been modified, or have been extended or renewed may be subject to Section 409A (even if such modifications, extensions or renewals occurred prior to 2005). These stock option and SAR awards may be exercised or cancelled by December 31, 2005 under this transition rule, as well.

Privately-held employers, as well as those that have recently become publicly held, should review the methods used to determine the fair market value of the stock subject to outstanding awards, and the exercise prices of such awards, in order to identify the discounted awards that may be subject to Section 409A. Also, employers should consider whether outstanding stock option and SAR awards that have been modified, extended or renewed are subject to Section 409A.

- *Substitution of Fair Market Value Awards for Discounted Awards.* Discounted stock option and SAR awards generally will be subject to Section 409A and will not comply with Section 409A without significant changes. An employer may cancel a discounted stock option and SAR award, and substitute a non-discounted stock option or SAR award for the cancelled award, by December 31, 2006 under a transition rule. The

substituted award will not be subject to Section 409A if the exercise price is not less than the fair market value of the stock on the grant date of the original award. The substituted award must not change the number of shares of stock subject to the award or provide any additional benefits. The substitution will not result in a “material modification.” A discounted award can be exercised by December 31, 2005 under the transition rule described above. If a discounted award is exercised during 2006, prior to the substitution, the exercise will result in a violation of Section 409A.

The employer may provide the employee with a cash or stock payment in the amount of the lost discount, but if the employer wishes to do so, the substitution of the non-discounted award and the payment of cash or stock for the lost discount must be made by December 31, 2005. The employer may provide the lost discount in other ways that are exempt from, or comply with, Section 409A. Also, any dividend equivalent rights with respect to the award may need to be amended to comply with Section 409A by December 31, 2005.

- *New Limitations on the Stock Underlying Awards.* Stock option and SAR awards with a fair market value exercise price at grant will not be subject to Section 409A only if the stock underlying the award meets certain requirements. The stock underlying the award must be common stock of the employer or an affiliated company. The common stock generally must be readily tradable on an established securities market, if the employer is publicly held or a subsidiary of a publicly-held company. If the employer and its affiliated companies are privately held, the common stock underlying the award must be the class of common stock that has the greatest

aggregate value of common stock issued and outstanding (or common stock with substantially similar rights to stock of such class, other than with respect to voting rights). The stock must not have liquidation or dividend preferences or be subject to permanent repurchase provisions at a price other than fair market value. Special affiliated company rules apply for purposes of determining the common stock. Under a transition rule, stock option and SAR awards granted prior to January 1, 2005 will be treated as satisfying these requirements, if the stock underlying the award was common stock of the employer or an affiliated company.

Stock option and SAR awards will be subject to Section 409A if the stock underlying the award is preferred stock, or the stock of a subsidiary of a publicly-held company, or otherwise fails to satisfy the above requirements. Stock options and SAR awards that are subject to Section 409A because of the underlying stock may be exercised or cancelled by December 31, 2005 under the transition rule described above.

- *Make Changes to Payment Elections for Amounts Payable in 2006.* A transition rule permits an employee to change the time and form of payment of deferred compensation subject to Section 409A by December 31, 2006. The time and form of payment must comply with Section 409A. However, the transition rule does not permit an employee to make a payment election change in 2006, if the change affects payments that otherwise would be received in 2006, or the change would cause a payment to be made in 2006. In order to change a payment election for amounts that otherwise may be payable in 2006 or to accelerate payments into 2006, an employee must make the new payment election by December 31, 2005.

Employers may wish to provide this payment election change opportunity by December 31, 2005. An employee will have until the end of 2006 to change the timing and form of payment for deferred compensation that otherwise is payable in 2007 or a later year, provided that the payments under the new payment election will not be made in 2006.

- *Amend Plans for Delayed 2005 Deferral Elections.* Section 409A generally requires that an employee make an election to defer compensation for services prior to the calendar year in which the employee performs the services. A transition rule permitted deferral elections on or before March 15, 2005 for compensation earned during 2005 and after the election date. An NQDC plan that allowed employees until March 15, 2005 to make deferral elections for 2005 compensation under this transition rule must be amended by December 31, 2005 to provide for the special deferral election date.
- *Make 2006 Deferral Elections.* Section 409A generally requires that an employee's deferral election for compensation for services to be performed in 2006 be made by December 31, 2005. The delayed deferral election transition rule available in 2005 (that permitted deferral elections by March 15, 2005) does not apply to 2006. Special rules under Section 409A apply to deferral elections by newly eligible participants and for performance-based compensation.

- *Six Month Distribution Delay for Officers.* Section 409A requires that distributions under an NQDC plan or arrangement to a "specified employee" upon separation from service be delayed until six months following separation from service. A "specified employee" generally includes the officers of a publicly-held corporation and certain officers of its subsidiaries. Employers must determine which employees are subject to this six-month distribution delay rule, and will need to assemble and analyze the information required to determine the "specified employees."

The proposed regulations provide for an annual "identification date" for purposes of determining the "specified employees," and apply the determination to those employees who have separations from service during the 12-month period beginning three months after the "identification date." Employers must designate the "identification date" (unless December 31 is used). Special rules apply for purposes of determining the "specified employees" of employers that are part of an affiliated group of companies.

Other than for these issues, the proposed regulations extend much of the earlier transition relief provided by Notice 2005-1 through December 31, 2006. For example, except as described above, employers generally have until December 31, 2006 to amend their non-qualified deferred compensation plans for Section 409A compliance.

The proposed regulations expand and modify the guidance provided in Notice 2005-1, which remains in effect until the issuance of final regulations. Until the Treasury Department and the IRS issue final regulations, employers are required to comply in operation with Section 409A in good faith (*i.e.*, using a reasonable interpretation of the rules). Employers may rely on the proposed regulations and Notice 2005-1 as good faith compliance with Section 409A until the final regulations are published.

Endnotes

- ¹ Other Latham & Watkins Client Alerts related to Section 409A may be accessed via this link: [<http://www.lw.com>].

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