

New Deferred Compensation Tax Rules: **FAQs**

On December 20, 2004 Treasury and the IRS released Notice 2005-1 setting forth their initial guidance on the new nonqualified deferred compensation legislation embodied in Section 409A. We issued an Alert! on December 22, 2004, summarizing some of the key provisions of the guidance. In the weeks since the guidance was issued we have received many inquiries as to how the legislation will affect various situations. In this Alert, we address some of these frequently asked questions. For ease of reference, our initial Alert! on Section 409A on October 14, 2004 can be found at www.cooley.com/news/alerts.aspx?ID=000038715520 and our December 22, 2004 Alert! on the guidance can be found at www.cooley.com/news/alerts.aspx?ID=000038783320.

Frequently Asked Questions

What decisions/elections must be made immediately?

1. Notice 2005-1 permits deferral elections for 2005 compensation to be made until March 15, 2005 for plans in existence on December 31, 2004. It should be noted that a participant who is unsure of the amount he or she wants to defer (under a plan in existence on December 31, 2004) may still want to make a deferral election as to the maximum amount since the participant will have until December 31, 2005 to revoke the election or to reduce the amount of the deferral. Also, the participant will have until December 31, 2005 to conform the distribution dates to the new requirements.

2. During the course of a widely attended conference call on January 6, 2005, Treasury and IRS officials indicated that a company with a non-complying (but grandfathered) plan will have to decide whether (a) to rely on the grandfather exception or (b) to allow participants to withdraw from the plan. Apparently, if the company decides to rely on the grandfather exception for one participant, it will have to rely on the grandfather exception for all participants. Accordingly, it cannot allow some participants to operate under the grandfathered provisions and allow other participants to either elect to withdraw from the plan or to continue participation under a compliant plan. It is not clear that such position is correct; however, until there is further clarification companies should assume that they will have to decide whether to rely on grandfather status or not before any participant is permitted to act under grandfathered provisions.

3. Treasury and the IRS also confirmed that if a grandfathered plan were to lose its grandfathered status after December 31, 2005 (for example, pursuant to a material modification in 2007), the grandfathered status will be lost retroactive to January 1, 2005. While this observation does not directly require an immediate decision, it emphasizes the care that has to be exercised to determine whether or not to rely on the grandfather exception.

My company went public recently (or is in the process of going public). Prior to the registration statement going effective, we agreed to restate our financial statements

to take into account the possibility that the options we previously granted were granted with an exercise price that was less than the fair market value of the stock on the date the options were granted. None of the options had vested as of January 1, 2005. Will the options be discounted stock options subject to Section 409A?

Notice 2005-1 makes clear that an “incentive stock option” (an “ISO”) is not subject to Section 409A. In order to be an ISO, an option must have an exercise price that is not less than the fair market value of the stock on the date of grant as determined in good faith by the Board of Directors at the time the option was granted. Assum-

Key Attorney Contacts

Soo Kim 415/693-2232
skim@cooley.com
Dan Meehan 720/566-4061
dmeehan@cooley.com
Buff Miller 650/843-5351
bmiller@cooley.com
Thomas Reicher 415/693-2381
treicher@cooley.com
David Walsh 703/456-8021
dwalsh@cooley.com
Thomas Welk 858/550-6016
twelk@cooley.com

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ing that the Board can show that its earlier determination was made in good faith in accordance with the ISO regulations, the agreement with the SEC arguably should not result in the ISO losing ISO status or becoming subject to Section 409A.

Notice 2005-1 makes clear that a nonqualified stock option must have an exercise price that meets the date of grant fair market value test and that the Board is required to use a "reasonable" valuation method in determining fair market value for this purpose. The Notice indicates that a method based on trading prices for publicly traded companies is generally reasonable. For private companies, the Notice indicates that a valuation method that takes into account factors such as the following would be one (but perhaps not the only) reasonable method: The company's net worth; its prospective earning power; its dividend-paying capacity, the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange.

We encourage you contact us if you are concerned about the possible application of Section 409A to either ISOs or nonqualified stock options.

We granted nonqualified stock options with a discounted exercise price. How can we amend the options to avoid the application of Section 409A?

1. Notice 2005-1 permits the company and the optionee to agree to increase the exercise price of the NSO by the amount of the discount on the date the option was granted. If such amendment is completed by December 31, 2005, the NSO will be treated as if it satisfied the date of grant fair market value test. It is less clear whether (and under what circumstances) the company can agree to pay the employee the amount of the prior discount in order to preserve the original benefit of the discount.

2. During 2005, the company and the employee can apparently convert the spread associated with the discounted NSO into a traditional nonqualified deferred compensation plan with distribution and other provisions that comply with the new Section 409A requirements.

3. During 2005, the company and the employee can amend the option to permit exercise only at times permitted under Section 409A. As such an amendment is likely to significantly reduce the value of the option for the employee, we believe that this approach will rarely be used.

4. During 2005, the company and the employee can exchange the option for a stock grant. Stock grants generally are not subject to Section 409A.

5. During 2005, the company and the employee can exchange the option for cash, or a combination of cash and stock.

Note that the foregoing changes typically will require the optionee's consent and may also have financial accounting consequences for the company. Some of the foregoing alternatives may also have immediate tax consequences.

We provide for double trigger severance pay following a change in control, unless the recipient is terminated with "cause" or leaves voluntarily. Will Key Employees be required to wait 6 months before collecting their severance benefit?

Treasury and the IRS believe that the 6-month delay would be required in this situation in order to comply with Section 409A. This position is unfortunate since it puts an employee with a double trigger benefit in a worse position than an employee with a qualifying single trigger benefit. In other words, a Key Employee could receive an immediate payment on a qualified change of control assuming termination of employment were not also required. Thus, a Key Employee with a double trigger benefit who is terminated upon a change of control has not only lost his job, he must wait 6 months to receive his severance. Although

it is not entirely clear, the 6-month delay may not be required if certain exceptions are available, possibly including the "short-term deferral" exception if the severance amounts is required to be paid within the first 2½ months after the end of the taxable year of termination.

We have a deferred compensation plan with grandfathered benefits. We plan to continue to have a deferred compensation plan in the future and will make the needed changes to the plan for future deferrals. Should we amend the old plan or adopt a new plan?

While it is clear that a company can amend a grandfathered plan to comply with Section 409A for future benefits, we are generally recommending that a new plan be adopted. Even if a new plan is adopted, the company will have to administer the grandfathered deferrals separately from the future deferrals. Accordingly, the company will have to track the grandfathered deferrals separately from the future deferrals and will have to use separate election forms. In our view, adopting a new plan reduces the confusion (and risk of an inadvertent violation of Section 409A) associated with properly administering the plan(s).

We are negotiating a severance package with an executive. The executive holds a vested incentive stock option that is currently "in-the-money" (i.e., the value of the stock is higher than the exercise price). When the ISO was granted, the ISO provided that it would terminate 3 months following the termination of the executive's employment. What are the implications of agreeing to allow the executive to exercise the option at any time up to 12 months after his termination of employment?

1. If the ISO were amended to increase the post-employment exercise period and the executive were to accept such amendment, the option would be considered a newly granted nonqualified stock option whether or not the executive were to take advantage of the additional exercise period. [NOTE: It is likely that the acceptance of the amendment by the executive would prevent the parties

from taking the position that the amendment was “inadvertent.”] Thus, it would appear that the option is subject to Section 409A as a discounted stock option (resulting in application of immediate taxation and penalties) unless certain exceptions apply.

2. One exception that appears to be available is the short-term deferral rule. If the terms of the extended exercise arrangement require that the option be exercised no later than 2½ months after the end of the tax year in which the option was amended, Section 409A should not apply.

3. The 2005 transition rules may provide relief in situations where the extended exercise period terminates any time during 2005. However, it is not clear whether the optionee would be subject to tax under other tax rules (such as the “constructive receipt” doctrine) at the time the option period expires.

We encourage you contact us if you are contemplating changes to an executive’s stock options.

We understand that deferred compensation payments must be tied to specific dates or permitted events to comply with Section 409A. Is there a grace period following the date/event during which the company may make the payment and not create a Section 409A violation?

Treasury and the IRS have not issued specific guidance creating a grace period or other safe harbor for payments. They have indicated informally that a payment within the same calendar year as the date/event should be permissible. This suggests, for example, that December 31 generally should not be selected as a payment trigger date.

We are planning to grant in 2006 restricted stock units with annual vesting over 3 years. Our plan permits participants to elect to defer the receipt of the underlying stock past the scheduled vesting date. We understand that the deferral election with respect to the first installment will have to be made by December 31, 2005 (in order to have the deferral election take place prior to

the calendar year of the start of the service period). By when must the participant make the deferral election with respect to the second and third installments?

Treasury and the IRS have indicated that the deferral elections with respect to the second and third installments must also be made by December 31, 2005.

We are a partnership/LLC. We would like to set up a deferred compensation plan for employees who are not partners/members, with a payout triggered by a change in control. Will this comply with Section 409A?

Apparently not. Treasury and the IRS have indicated that a change in control is a 409A-compliant payout only for corporations.

Will an IPO constitute a change in control for purposes of Section 409A?

No. The Notice indicates that an IPO generally will not constitute a change in control, and therefore will not be a permissible deferred compensation distribution event.

We have an arrangement for employees that may not comply with Section 409A. What is the employer’s obligation under Section 409A?

The employer must report the income includible by employees under a noncomplying arrangement on Form W-2, and must withhold income and employment taxes on that amount. The Notice does not indicate whether employers must also withhold the 20% penalty amount imposed by Section 409A, however, IRS officials have informally indicated that the penalty will be subject to withholding.

Who should I contact at Cooley to discuss Section 409A questions?

Please contact one of our attorneys listed at the front of this Alert. ■