

CLIENT ALERT

APRIL 2005

DEFERRED COMPENSATION CHANGES UNDER THE AMERICAN JOBS CREATION ACT OF 2004

This memorandum briefly summarizes the effects of the American Jobs Creation Act of 2004 on nonqualified deferred compensation arrangements, including discount stock options.

Introduction

The American Jobs Creation Act added Section 409A to the Internal Revenue Code, fundamentally changing the tax rules governing nonqualified deferred compensation, including discount stock options. While the rules continue to evolve in this area, this memorandum briefly summarizes the act and comments on some important issues for employers.

Section 409A creates broad new rules governing the timing of deferral elections, permissible distribution events, and the timing of tax inclusion for nonqualified deferred compensation. Deferred compensation generally exists where a service provider has a legally binding right to compensation during a taxable year that becomes payable in a later year (e.g., a right to a cash payment today that is deferred into a future taxable year).

Under Section 409A, all amounts deferred under a nonqualified deferred compensation plan are currently includable in gross income to the extent not subject to substantial risk of forfeiture and not previously included as gross income, unless the plan satisfies new requirements regarding: (i) the timing of deferral elections, (ii) permissible distribution events, and (iii) prohibiting acceleration of benefits. Failure to satisfy these rules will result in current income inclusion of all

deferrals for affected participants, plus interest on the deferrals calculated at the IRS underpayment rate, plus 1 percent. The amount required to be included in income also is subject to a 20 percent additional tax.

Effective Date and Transition Guidance

Effective Date. Generally, Section 409A applies to amounts deferred in taxable years beginning after December 31, 2004, and amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. It applies to discount options that vest or are granted after December 31, 2004. The amount is considered deferred before January 1, 2005, if the service provider has a legally binding right to be paid the amount and the right to the amount is earned and vested as of December 31, 2004.

Material Modification. A modification of a plan is material if a benefit or right existing as of October 3, 2004, is enhanced or a new benefit or right to a plan is added, even if the new benefit is allowed under the act. If the employer exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004, a material modification will have occurred. However, a material modification will *not* occur if an employer exercises discretion over the time and manner of payment of a benefit to the extent that such discretion was allowed under the terms of the plan as of October 3, 2004.

The amendment of a plan to bring it into material compliance with the act, the reduction of an existing benefit, or the

amending of an arrangement to stop future deferrals under a plan will not be considered a material modification. Amending a plan on or before December 31, 2005, to terminate participation and distribute the amounts of deferred compensation will not be treated as a material modification, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs. The amendment does not need to apply to all participants in the plan.

Required Actions for Existing Plans. A plan adopted before December 31, 2005, will not violate the act if the plan is operated in good-faith compliance with the provisions of the act and available guidance during calendar year 2005, and the plan documents are amended on or before December 31, 2005, to comply with the provisions of the act.

Nonqualified Deferred Compensation Plans

Section 409A defines a nonqualified deferred compensation plan as any plan (including an arrangement covering one person) providing for the deferral of compensation, other than a tax-qualified plan, bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. The new rules appear to affect many types of arrangements that defer compensation, including supplemental executive retirement plans, certain stock appreciation rights (SARs), restricted stock units, discount stock options, and individual executive severance and change-in-control agreements.

Recent guidance has provided helpful clarification of arrangements not subject to

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Section 409A (e.g., restricted stock, public-company stock-settled SARs, short-term deferrals, and nonstatutory stock options with an exercise price at least equal to the fair market value of the underlying stock). However, many unanswered questions remain. For example, it is not clear how Section 409A applies to severance or change-in-control benefit arrangements. Also uncertain is the extent to which modifying an outstanding in-the-money option (e.g., extending the exercise period) is deemed a new grant of an option with a below fair-market-value-exercise price, and therefore subject to Section 409A. Until the IRS issues additional guidance, employers will need to exercise caution to avoid inadvertently violating Section 409A when implementing or amending compensation arrangements involving future payments. The IRS has provided the following guidance regarding equity compensation awards, short-term deferrals, and severance plans:

Nonstatutory Stock Options. Guidance provides that an option to purchase stock of the issuer will not be treated as deferred compensation, provided that: (i) the exercise price of the option is not less than the fair market value of the underlying stock on the grant date; (ii) the receipt, transfer, or exercise of the option is subject to taxation under Section 83 of the Code; and (iii) the option does not include any feature for the deferral of compensation other than the deferral of income recognition until the later of exercise or disposition of the option (e.g., a cash-out in connection with a corporate transaction).

An option granted with an exercise price below fair market value generally will be treated as deferred compensation if it is granted or vests on or after January 1, 2005. An option that is deferred compensation and is exercisable at any time after vesting potentially violates the requirements of Section 409A. As a result, the optionee generally will recognize ordinary income prior

to exercise in the year in which the option vests and an additional 20 percent tax, plus interest. The issuer will have a corresponding withholding and reporting obligation with respect to the amounts includible in income under Section 409A (other than the 20 percent tax and interest). The additional 20 percent tax also may apply in subsequent calendar years as the fair market value of the stock underlying the option continues to increase. We still are waiting for additional guidance from the IRS regarding the timing of taxation and the measurement of the additional 20 percent tax.

Comment: Nonstatutory stock options will need to be granted at or above fair market value to avoid being subject to the act. Until further guidance is issued, reasonable valuation methods may be used. Also, the grant of unvested shares pursuant to an option exercise (i.e., an “early-exercise” arrangement) would not itself constitute a deferral causing the option to become subject to the act. To the extent an option grants the recipient a right other than to purchase stock at a defined price and such additional rights allow for the deferral of compensation, the entire arrangement is deferred compensation and subject to the act. **As a practical matter, private companies granting options should consider obtaining an independent third-party valuation of the underlying shares prior to grant, or should at a minimum be able to document and support the methodology used in pricing options.**

Restricted Stock, Statutory Stock Options. IRS guidance provides that restricted stock, incentive stock options, and options granted under an employee stock-purchase plan qualified under Code Section 423 are not subject to the act. However, guidance provides that a plan that provides a service provider with a legally binding right to receive stock (whether or not restricted) in the future may constitute a nonqualified deferred compensation plan covered by the act. For

example, a restricted stock unit is considered nonqualified deferred compensation if the shares related to the restricted stock unit are not paid out shortly after vesting.

Stock Appreciation Rights. SARs are equity awards similar to options, except that on exercise, no exercise price is paid. Instead, the net profit shares are issued. IRS guidance states that SARs are not treated as deferred compensation subject to the act, if: (i) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, (ii) the stock of the employer subject to the SAR is traded on an established securities market, (iii) only such traded stock of the employer may be delivered in settlement of the right upon exercise, and (iv) the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the SAR.

There is transition relief for certain existing SARs. Until further guidance is issued, pursuant to a program in effect on or before October 3, 2004, a payment of stock or cash pursuant to the exercise of a SAR or the cancellation of a SAR for consideration will not be considered deferred compensation if: (i) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the SAR was granted; and (ii) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

Comment: IRS guidance clarifies that SARs that may be settled in cash and SARs issued by private companies will be subject to Section 409A. However, covered SARs can be structured to satisfy Section 409A by, for example, requiring a fixed payment date (e.g., requiring payment at vesting), which is not likely to be attractive to most employees.

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Short-Term Deferrals. Pending further guidance, a deferral of compensation generally does not occur with respect to amounts actually or constructively received by the service provider by the later of: (i) two-and-a-half months from the end of the service provider's taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or (ii) the date that is two-and-a-half months from the end of the service recipient's taxable year in which the amount is no longer subject to a substantial risk of forfeiture. For example, bonuses awarded prior to year-end but not actually paid until early the following year are generally not subject to the act. However, if the service provider is permitted the choice to receive a payment in a year later than the year in which the payment is no longer subject to a substantial risk of forfeiture, the two-and-a-half month rule does not apply, and the payment is subject to the act.

Severance Plans. Severance-pay benefits provided by a plan that is either collectively bargained or does not cover service providers who are key employees, need not meet the act's requirements for calendar year 2005, provided that the plan is amended before December 31, 2005. Severance arrangements that involve key employees are generally subject to the act, but such arrangements may be exempt if payments are made on or prior to the date two-and-a-half months from the end of the calendar year in which

termination occurs. This point is unclear under current guidance.

Reporting and Withholding Requirements for Deferred Amounts

The act requires annual reporting on Form W-2 or 1099-MISC, as applicable, of all deferred compensation for the year, regardless of whether or not the compensation is includible as gross income. The information reporting requirements are not effective for amounts actually deferred in calendar years beginning before January 1, 2005. Employers will have a withholding obligation with respect to income tax (but not additional taxes) for amounts includible in gross income of an employee under Section 409A. Amounts deferred also are subject to FICA taxes under existing rules. For calendar year 2005, amounts includible in gross income under Section 409A but not actually or constructively received may be treated as paid for income-tax withholding purposes on any date on or before December 31, 2005.

If you have any questions concerning the effect of the American Jobs Creation Act on your benefit plans, or need assistance with plan amendments required by the act, please feel free to call any member of our Employee Benefits & Compensation practice.