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CRITICAL YEAR-END GUIDANCE— IRS ISSUES PROPOSED REGULATIONS ON DEFERRED COMPENSATION UNDER CODE SECTION 409A

SUMMARY OF SECTION 409A REQUIREMENTS

As part of the American Jobs Creation Act of 2004, Code Section 409A was enacted by Congress to regulate "nonqualified deferred compensation plans." Section 409A made sweeping changes, some of which were quite surprising to practitioners and employers. Under Section 409A, a deferral of compensation occurs if an employee or service provider has a legally binding right during a year to receive compensation that is not actually or constructively received and is payable in a later year. In general, Section 409A expanded the definition of nonqualified deferred compensation to include many arrangements never before considered to be deferred compensation (e.g., severance arrangements, equity-based compensation, and compensation arrangements with delayed payments). It imposes specific requirements regarding the timing of elections to defer compensation and elections of time and form of distribution. Section 409A also prohibits acceleration of distributions from nonqualified deferred compensation plans and imposes stiff penalties for violation of the Section 409A requirements.

Section 409A was enacted in October 2004 and generally effective for amounts deferred on and after January 1, 2005, creating havoc for employers scrambling to comply. Notice 2005-1 was issued in December 2004 to provide interim guidance for 2005. Pursuant to Notice 2005-1, any amounts deferred prior to January 1, 2005 may be "grandfathered" and subject to pre-Section 409A rules if the plan is not materially amended. The requirement to amend plans to comply with Section 409A as set out in Notice 2005-1 was December 31, 2005. Plans subject to Section 409A (i.e., deferrals not "grandfathered" under the old rules or arrangements that are not specifically exempt from coverage) must be operated in "good faith compliance" with Section 409A despite the delayed amendment. Notice 2005-1 provides that an employer may avoid compliance with Section 409A completely by terminating the deferred compensation plan and distributing all amounts to participants prior to December 31, 2005. If a deferred compensation plan is not specifically exempt from the application of Section 409A and fails to comply with its requirements during a year, all vested amounts deferred for the current year and prior years are included in the participant's gross income (if not previously included). The amounts included in income also are subject to a 20% penalty and interest.

PROPOSED REGULATIONS -- EXTENSIONS AND TRANSITION RELIEF

On September 29, 2005, the IRS issued much anticipated guidance regarding the application of Internal Revenue Code Section 409A to nonqualified deferred compensation plans. The proposed regulations clarify the application of Section 409A to these arrangements. The new guidance also provides an extension for complying with some but not all of the new requirements. We will summarize certain key provisions of the proposed regulations and actions that employers must take for compliance with Section 409A.

Actions Required In 2005

1. Identification of Plans. Employers must identify plans, programs, arrangements and agreements that are or may be subject to Section 409A. For any plans that may be subject to Section 409A, avoid any "material modifications" that may result in loss of grandfathered status.

2. Termination of Plans. Notice 2005-1 allows an employer to avoid compliance with Section 409A by terminating a grandfathered plan and distributing all amounts (including income) to participants prior to December 31, 2005. This deadline has not been extended.

3. Termination of Elections. Notice 2005-1 also allows participants to terminate participation in a deferred compensation plan or cancel a deferral election by December 31, 2005. This deadline has not been changed.

4. 2006 Deferral Elections. Elections to defer 2006 compensation must be made prior to December 31, 2005 (with the exception of performance-based compensation, for which a later election may be allowed). Also remember that in a 401(k) mirror plan in which the employee's deferral election applies to amounts in excess of qualified plan contribution or compensation limits, deferrals cannot "float" automatically with changes made by the employee under the qualified plan. Employee elections under the qualified plan may need to be limited accordingly.

Deadlines Extended/Transition Relief

1. Plan Amendments/Operation. The deadline for amending plans to comply with Section 409A has been extended to December 31, 2006. A plan must be operated in good faith compliance with Section 409A and Notice 2005-1 through that date. To the extent that a provision in the proposed regulations is inconsistent with Notice 2005-1, it is permissible to comply with the proposed regulations for good faith compliance with Section 409A.

2. Payment Elections. A change in a payment election of time or form of payment generally (i) must be made at least 12 months before the scheduled payment date,

(ii) must delay the payments for at least five years from the initially scheduled payment date, and (iii) cannot accelerate payment. The proposed regulations provide that participants have until December 31, 2006 to make a new election of the time and form of payment of their benefits. However, a participant cannot change an election during 2006 with regard to payments the participant would receive in 2006, or cannot make an election that would cause payments to be made in 2006. Any action that would affect 2006 payments must be made in 2005.

3. Payments Based on A Qualified Plan Election. Payments under nonqualified deferred compensation plans that are controlled by an election of the time and form of benefits from a qualified retirement plan (e.g., payments from a Supplemental Retirement Plan that are tied to a Retirement Plan election) can be made or begin no later than December 31, 2006 without violating Section 409A if the determinations are made in accordance with the terms of the plan as of October 3, 2004.

4. Substituting Non-Discounted Stock Options and SARS. The proposed regulations generally extend the deadline for substituting nondiscounted for discounted stock options and stock appreciation rights until December 31, 2006. Options and SARs granted and exercisable at fair market value generally are not subject to Section 409A. The transitional relief allows nondiscounted options to be substituted for discounted options to avoid having the options and SARs subject to Section 409A.

ADDITIONAL GUIDANCE ON KEY PROVISIONS

Short-Term Deferral Exemption Permanent

As provided in Notice 2005-1, a deferral of compensation does not occur (assuming no actual election to defer) if the plan requires payment, and the amount is actually or constructively received, by the employee by the later of 2 ½ months after the end of the employee's taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or 2 ½ months after the end of the employer's taxable year in which the amount is no longer subject to a substantial risk of forfeiture. The regulations provide that payments made after the 2 ½ month period are allowed if the delay is due to unforeseeable administrative or solvency issues if made as soon as reasonably practicable. It is not necessary for a plan to state that payments will be made within 2 ½ months for the short-term deferral exemption to apply. However, if any payment is not made within 2 ½ months, the result is an automatic violation of Section 409A (unless the delay is due to solvency or unforeseeable administrative issues).

Expansion of Stock Option and SAR Exception

A nonqualified stock option is not subject to Section 409A if the option is granted for not less than fair market value of the underlying stock on the date of grant, the option

is taxable under Code Section 83, and the option does not allow for deferral of compensation. Under Notice 2005-1, only SARs based on publicly-traded stock which were settled in stock would be exempt from Section 409A. The proposed regulations expand the exemption to apply rules similar to stock options without regard to whether the SAR is settled in cash or stock or based on stock of a public or private corporation. The regulations provide that a SAR is not subject to Section 409A if (i) compensation from a SAR cannot be more than the difference between the fair market value of the stock as of the date of grant and the fair market value on date of exercise, (ii) the exercise price of the SAR may never be less than the fair market value of the underlying stock on date of grant, and (iii) the SAR does not allow for deferral of compensation. The regulations provide that the number of shares covered by the grant must be fixed on the date of grant.

In addition, the proposed regulations provide that awards must be based on "service recipient stock," defined as common stock which is tradable on an established securities market or, if no such stock exists, the class of common stock with the greatest aggregate value of any class of common stock issued and outstanding. Importantly, service recipient stock does not include preferred stock or stock with a mandatory repurchase obligation, put or call right not based on fair market value. The regulations also provide guidance as to the meaning of "service recipient," specifically addressing joint venture arrangements. The proposed regulations raise issues regarding use of parent company stock rights for employees of affiliates. The proposed regulations also provide safe harbor rules for determining fair market value and for determining whether modifications of stock rights would result in treatment as a new grant or an additional deferral right.

Important Expansion of Severance Pay Exemption

Notice 2005-1 provides that a severance plan which pays benefits on involuntary termination or which satisfies the Department of Labor's severance pay safe harbor regulation (29 CFR 2510.3-2(b)) would be exempt from Section 409A for 2005 if it was a collectively bargaining plan or if it did not cover key employees. The proposed regulations, which use the term "separation pay arrangements," provide that arrangements that provide for severance pay (e.g., severance plans, change in control arrangements, and severance clauses in employment agreements) are subject to Section 409A. The regulations contain an important exemption from Section 409A for a separation pay arrangement that pays on involuntary termination of employment or under a window program generally limited to one year if (i) the total amount payable under the arrangement is not in excess of two times the employee's annual compensation or, if less, two times the Code Section 401(a)(17) limit ($210,000 for 2005); and (ii) payments are made no later than the end of the second calendar year after the year in which the separation from service occurs.

A severance arrangement that pays on involuntary termination and meets the short-term deferral exception (i.e., all amounts are paid within 2 ½ months of the end of the year in which termination occurs) would not be subject to Section 409A. The preamble to the proposed regulations indicates that the short-term deferral exception may

not apply to severance that is paid on a voluntary termination (e.g., termination for "good reason"). Further guidance on this issue is expected from the IRS.

Certain reimbursements paid after separation from service, such as business expense reimbursements, medical expenses, and moving and relocation payments are not subject to Section 409A if they only cover expenses incurred and reimbursed prior to the end of the second calendar year following the year in which the separation from service occurs.

If you have any questions regarding compliance with Section 409A and the impact on your plans and agreements, please contact Dana Thrasher (205-226-5464; dthrasher@constangy.com), Rebecca Amthor (205-226-5460; ramthor@constangy.com), or the firm attorney that you regularly contact.