

Nonqualified Deferred Compensation Plan Guidance Under The American Jobs Creation Act of 2004 and Notice 2005-1

I. Introduction.

On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 (the “Act”) into law. Among other things, the Act adds section 409A to the Internal Revenue Code of 1986, as amended (the “Code”). Code Section 409A significantly revises the rules affecting the design and operation of many types of compensation arrangements and agreements that are now considered to be non-qualified deferred compensation plans (“NQDC Plans”), as defined by Code Section 409A and the guidance issued thereunder. Specifically, Code Section 409A provides that unless certain requirements are met, amounts deferred under a NQDC Plan for all taxable years are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture and have not been previously included in gross income. In addition, Section 409A includes rules applicable to certain trusts or similar funding arrangements associated with NQDC Plans, where such arrangements are located outside the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the plan sponsor.

On December 20, 2004 the Internal Revenue Service (the “IRS”) released the first round of transitional guidance in the form of Notice 2005-1 (sometime referred to as the “Notice”), which is written in Q&A format and provides much-needed transition relief and interpretations of the Act’s key terminology. The Notice is intended to be the first phase of a series of guidance issued in 2005, and until additional guidance is provided, taxpayers should base their positions on good faith, reasonable interpretations of the Act, its legislative history, and Notice 2005-1. References in this Alert to Q&A’s are to the Q&A’s in the Notice.

It is important to note that although the Act makes a number of extensive changes, it does not alter the application of any other provision of the Code or common law tax doctrine. Thus, Code Section 409A should be treated as an “overlay” to existing rules applicable to NQDC Plans.

Because the Act’s definition of nonqualified deferred compensation is significantly broader than its traditional meaning, and noncompliance with the new rules results in onerous adverse tax consequences to the affected employees, employers should focus now on identifying all arrangements that fall within the Act’s purview, and on making the necessary changes to bring such arrangements into compliance in 2005. To assist in this effort, this outline describes the major points of the Act as explained by the guidance contained in Notice 2005-1.

II. Covered Plans and Arrangements.

A. Parties involved.

1. **Service Recipient.** The “service recipient” refers to the person for whom the services are performed (e.g., an employer). All employers or other service recipients that are members of a controlled group of entities, as defined under Code Sections 414(b) and (c), are treated as a single employer or service recipient. This Alert uses “service recipient” and “employer” interchangeably. Q&A-5.

2. **Service Provider.** The “service provider” is the individual providing the services (e.g., employees and independent contractors). Service providers also include (i) a personal service corporation (as defined in Code Section 269A(b)(1)), or a non-corporate entity that would be a personal service corporation if it were a corporation, and (ii) a qualified personal service corporation (as defined in Code Section 448(d)(2)), or a non-corporate entity that would be a qualified personal service corporation if it were a corporation. Code Section 409A does not apply to arrangements between taxpayers if all of the taxpayers use the accrual method of accounting. Code Section 409A also does not apply to a service provider actively engaged in the trade or business of providing substantial services (other than as an employee or director), provided that the service provider provides such services to at least two unrelated service recipients. This Alert uses “service provider” and “employee” interchangeably. Q&A-8.

B. Code Section 409A: Definition of “non-qualified deferred compensation plan.”

Under Code Section 409A(d)(1), a non-qualified deferred compensation plan is any “plan” that provides for the “deferral of compensation,” other than a “qualified employer plan” or a *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. Unless otherwise specifically excluded under the Act, or by future guidance, all forms of plans, agreements and arrangements that cause compensation to be deferred to another tax year are subject to the new rules.

1. **Definition: Plan.** A “plan” includes any agreement, method or arrangement, including an agreement, method or arrangement that applies to one person or individual. An agreement, method or arrangement may constitute a plan regardless of whether it is an employee benefit plan under Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). Therefore, the following arrangements and agreements are among the many forms of compensation covered by the Act’s broad definition of a NQDC Plan:

- Stock options granted at below-market value (discounted options)—options on employer stock granted at fair market value are not covered;
- Supplemental executive retirement plans (SERPs) and other non-qualified retirement arrangements;
- Restricted stock units, phantom stock and performance share plans;
- Certain severance pay programs;
- Code Section 457(f) plans;
- Certain stock appreciation rights (SARs);
- Many long-term or multi-year bonus or commission programs; and
- Any other employment, bonus or compensation agreements, even if covering only one employee, that results in the deferral of the taxation of compensation.

A plan may be adopted unilaterally by the service recipient or may be negotiated among or agreed to by the service recipient and one or more service providers or service provider representatives. Q&A-9.

a. Disaggregation Rule. Generally, the requirements of Code Section 409A are applied as if a separate plan (or plans) is maintained for each service provider. This means that if a NQDC Plan fails to meet the requirements of Code Section 409A in form or operation, only the service provider whose deferred compensation is affected is subject to taxation as a result of the failure. Q&A-2.

b. Aggregation Rule. Notice 2005-1 states that compensation is deferred under one of three mechanisms: an account balance plan, a non-account balance plan or an “other” plan. The Notice further provides that Code Section 409A is applied on an aggregate basis within each category; for example, all compensation deferred for a particular service provider under any account balance plans under which he has made deferrals is treated as deferred under a single plan. Therefore, noncompliance with Code Section 409A will result in taxation of all amounts deferred under all plans in the same category as the offending plan for the individual for whom there is noncompliance with Code Section 409A. Q&A-9

(i) Account Balance Plans. An account balance plan is one where a principal amount and the income attributable to that principal amount are credited to an individual account of the service provider. The benefits payable to the service provider are based solely on the balance credited to the individual account.

(ii) Non-account Balance Plans. A non-account balance plan is a plan that does not have the account balance structure of an account balance plan, and includes most supplemental executive retirement plans (SERPs) and other pension-type arrangements. In addition, plans that provide benefits in the form of an annuity commencing payment at employment termination and continuing for the life of the participant or for some other specified period would be non-account balance plans.

(iii) “Other” Plans. Arrangements that are neither account balance plans, nor non-account balance plans, such as discounted stock options, certain stock appreciation rights or certain other equity-based compensation.

2. Definition: Deferral of Compensation. A plan provides for deferred compensation if, under the terms of the plan, and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to the service provider in a later taxable year. If compensation may be unilaterally reduced or eliminated by the service recipient after the service creating the rights to compensation have been performed, the service provider does not have a legally binding right to compensation, and thus there is no deferred compensation. However, if facts and circumstances show that the discretion to reduce or eliminate the compensation is unlikely to be exercised, or that the discretion to reduce or eliminate compensation is available only upon a condition that is unlikely to occur, a service provider will be considered to have a legally binding right to compensation. Compensation is not subject to a unilateral reduction or elimination merely because it may be reduced or eliminated by the objective terms of a plan, such as the application of a provision creating a substantial risk of forfeiture. References to the deferral of compensation include references to income (whether actual or notional) attributable to such compensation. Q&A-4



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a. Payroll period exception. A deferral of compensation will not occur under Section 409A when an amount is paid after the end of the last day of the service provider's taxable year under the service provider's customary payroll timing arrangement.

b. Short-term deferral exception. A deferral of compensation will not occur if, absent an additional election to defer, at all times the provisions of the plan require payment within, and the amount is actually or constructively received by the service provider by, the later of (i) the date that is 2 ½ months from the end of the service provider's (e.g., employee's) first taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or (ii) the date this is 2 ½ months from the end of the service recipient's (e.g., employer's) first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

3. Definition: Substantial Risk of Forfeiture. Compensation is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial, and the entitlement to the amount is conditioned on either (i) the performance of substantial future services by any person, or (ii) the occurrence of a condition related to a purpose of the compensation. For these purposes, the condition must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). A condition that a service provider refrain from performing services does not create a substantial risk of forfeiture. Therefore, NQDC Plans that have traditionally relied upon noncompete agreements to provide a substantial risk of forfeiture will need to be amended to include the new Section 409A definition. Any added risks of forfeiture after the beginning of the service period or extension of the risk period under any circumstances, (even including third party action) is disregarded. The risk period can't extend beyond the time a person could otherwise elect to receive the compensation, unless the amount subject to risk (ignoring earnings) is materially greater than the amount that could otherwise have been elected to be received. The Notice contains special rules for determining whether a substantial risk of forfeiture exists in circumstances involving shareholder relationships, control of employer, etc, where the individual owns a significant amount of voting control or value of equity of the employer. Q&A-10.

4. Arrangements that are not NQDC Plans.

a. Stock options. An option to purchase stock of a service recipient other than an incentive stock option described in Code Section 422 (an "ISO") or an option granted under an employee stock purchase plan described in Code Section 423, will be considered to be a NQDC *unless*: (i) the exercise price is always at least equal to the fair market value of the underlying stock on the date the option is granted, (ii) the receipt, transfer or exercise of the option is subject to taxation under Code Section 83, and (iii) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under § 1.83-7 of the Treasury Regulations. Such options are not deferred compensation even if the stock received on the exercise of the option is subject to restrictions. Q&A-4.



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b. Stock appreciation rights.

(i) SARs under programs in effect on October 3, 2004. Until additional guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (“SAR”) (or an economically equivalent right), or the cancellation of such a right for consideration where such right is granted pursuant to a program in effect on or before October 3, 2004 is not 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 right 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. Q&A-4.

(ii) New SARs. A SAR does not constitute deferred compensation if (i) the SAR exercise price is never less than the fair market value of the underlying stock on the grant date, (ii) the stock of the service recipient is traded on an established securities market, (iii) upon exercise of the right, only stock of the service recipient may be delivered (*i.e.* it is a stock-settled SAR), and (iv) the right does not include any deferral feature other than the deferral of income from the grant date until the exercise date. (Note: There is no exception for SARs issued by a privately held company). Q&A-4.

c. Code Section 457(b) plans. Eligible plans under Code Section 457(b) are not subject to the requirements of Code Section 409A. However, the Code Section 409A rules apply to (i) Code Section 457(f) plans, (ii) Code Section 457(e)(12) plans for nonemployees, and (iii) grandfathered plans under prior Code Section 457 transition rules. Pending further guidance, state and local governments and tax exempt entities may rely on the definitions of *bona fide* vacation leave, sick leave, compensatory time, disability pay and death benefit plans for purposes of Code Section 409A’s applicability to Code Section 457(f) plans, and length of service awards to *bona fide* volunteers under Code Section 457(e)(11)(A)(ii) are not covered by Code Section 409A. However, Code Sections 409A and 457 work independently, and therefore employers are cautioned that they should not rely on the definition of “deferral of compensation” under Section 409A for purposes of taxation under Section 457(f). Q&A-6.

d. Exception for Qualified Employer Plans. Code Section 409A does not apply to qualified employer plans such as pension plans, 401(k) plans, 403(b) plans, simplified employee pension plans, SIMPLEs and IRAs. Code Section 409A also does not apply to *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefit plans, including Archer Medical Savings Accounts, Health Savings Accounts, or any other medical or health reimbursement account that meets the Code’s requirements, including non-discrimination. Q&A-3.

5. Other Coverage Issues.

a. Application of Code Section 409A to partners of a partnership. Code Section 409A may apply to arrangements between a partner and a partnership that provides for the deferral of compensation under a non-qualified deferred compensation plan. However, the Notice indicates that until further guidance is issued, taxpayers may treat the grant of equity interests in partnerships, and options to purchase partnership interests, in a manner consistent with the rules applicable to equity awards granted by corporations. The Notice also states that until further guidance, the issuance of a profits interest by a partnership for services generally will not be treated as resulting in a

deferral of compensation, even though the service provider is not required to recognize immediate income as a result of the grant of such an interest. Payments, other than certain payments pursuant to a written retirement plan, payable in liquidation of the interest of a retiring or deceased partner, generally will not be subject to Section 409A, but those rules may apply to payments treated as guaranteed payments to a partner not acting in his capacity as a partner (*i.e.* payments for services that are determined without regard to partnership income). Q&A-7.

b. Deferred Compensation Plans Whose Payout is Linked to a Qualified Plan. Prior to January 1, 2006, an election as to the timing and form of payment under a deferred compensation plan that is controlled by a payment election under a qualified plan will not violate Code Section 409A so long as the determination of timing and form is made in accordance with the terms of the deferred compensation plan as in effect on October 3, 2004. Q&A-23.

III. Effective Date and Transitional Relief.

A. General Effective Date.

Unless transitional relief applies, Code Section 409A is effective with regard to (i) amounts deferred in taxable years beginning after December 31, 2004, and (ii) amounts deferred in taxable years beginning before January 1, 2005 if the plan was materially modified after October 3, 2004. An amount is considered deferred before January 1, 2005, if the individual has a legally binding right to be paid the compensation and the amount is “earned and vested” as of December 31, 2004. An amount is earned and vested if the amount is not subject either to (i) a substantial risk of forfeiture (as defined in Code Section 83-3(c)), or (ii) a requirement to perform additional services. Therefore, a requirement to perform services after December 31, 2004 in order to receive an amount will preclude that amount from being considered deferred before January 1, 2005. Q&A-16. For example, a calendar year 2004 bonus that is conditioned on the employee’s employment on the date the bonus is paid in 2005 would not be earned and vested as of December 31, 2004 (although it would not be deferred compensation if paid by March 15, 2005).

With respect to non-account balance plans, the amount deferred before January 1, 2005 equals the present value of the amount the participant would receive if he terminated services as of December 31, 2004 and was paid the value of such entitlement at the earliest possible date allowed under the plan, provided that he has earned and is vested in such amount as of December 31, 2004. Q&A-17.

With respect to account balance plans, the amount deferred is the portion of the service provider’s account that is earned and vested as of December 31, 2004. Q&A-17.

B. Material Modification Effective Date.

Code Section 409A applies with respect to amounts deferred prior to January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. If a NQDC Plan’s provisions in effect prior to October 3, 2004 are not materially modified, the pre-Act rules will continue to apply to deferrals made before January 1, 2005, and earnings on such deferrals.



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1. Definition of Material Modification. Generally, a material modification is the enhancement of an existing benefit or right, or the addition of a new benefit or right under the plan. A material modification can occur by an amendment to the plan, or by the employer's exercise of discretion under the plan. For example, an employer's exercise of discretion to accelerate the vesting of benefits to a date before December 31, 2004 constitutes a material modification. However, if the granting of additional benefits under an existing plan can be demonstrated to be consistent with historical practices, the presumption that a material modification occurred can be rebutted. For instance, a history of granting options at the same time each year would be the sort of practice that could overcome the presumption. Q&A-18.

a. Actions that do not constitute material modifications. The following actions will not constitute material modifications:

(i) An employer's exercise of discretion over the time and manner of payment of benefits if the terms of the plan as of October 3, 2004 allowed for such discretion;

(ii) A modification of a notational investment measure, or the addition of a notational investment measure that qualifies as a "predetermined actual investment" as defined in §1.3121(v)(2)-1(d)(2) of the Treasury Regulations;

(iii) The exercise of a right permitted under the plan as in effect on October 3, 2004;

(iv) The reduction of an existing benefit or right;

(v) The amendment of a plan to stop future accruals;

(vi) The amendment of a plan on or before December 31, 2005, to terminate the plan and distribute amounts deferred, so long as the termination and distributions occur in the same taxable year; and

(vii) The cancellation and reissuance before December 31, 2005 to replace a stock option (discounted) or SAR that would be deferred compensation, so long as the number of options or SARs corresponds directly to the original number, and the new option or SAR does not provide any additional benefits other than those needed to avoid deferred compensation.

C. **Transition Relief.**

1. General Transitional Relief Rules. A plan adopted before December 31, 2005 will not be treated as violating Code Section 409A(a)(2), (3) or (4) only if (i) the plan is operated in good faith compliance with the provisions of Code Section 409A and Notice 2005-1 during the calendar year 2005, and (ii) the plan is amended on or before December 31, 2005 to conform to the provisions of Code Section 409A with respect to amounts subject to Code Section 409A. Q&A-19.



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A plan will be treated as operated in good faith if it is operated in accordance with Notice 2005-1, and to the extent issues are not addressed in Notice 2005-1, the plan is operated in accordance with a reasonable good faith interpretation of Code Section 409A, and in a manner that is not inconsistent with the plan's terms. However, if the plan's terms permit the exercise of discretion by either the service provider or the service recipient that would violate 409A, that exercise will not be considered operation in good faith compliance.

A plan may be amended to allow participants to make new payment elections with respect to amounts previously deferred under the plan that are subject to Code Section 409A, and the new payment elections will not be treated as impermissible changes to the form and timing of payments, or as violations of the anti-acceleration rule, so long as the plan is properly amended and the participant makes the new payment election on or before December 31, 2005. Similarly, an outstanding stock option or a SAR may be amended to provide for fixed payment terms consistent with Code Section 409A, or to permit holders of such rights to elect fixed payment terms consistent with Code Section 409A so long as the option or right is so amended, and any elections are made by December 31, 2005. Q&A-19.

2. **Transitional Relief Rules Applicable to Severance Plans.** Severance plans that are either (i) collectively bargained, or (ii) cover no key employees, are not required to meet the requirements of Code Section 409A during 2005 so long as those plans are properly amended by December 31, 2005. Plans that (i) pay no more than two times annual compensation over no more than two years, or (ii) only provide benefits upon involuntary employment termination are treated as severance plans for purposes of this transition rule under Section 409A. Q&A-19.

3. **Limited Rights to Terminate Participation or Cancel Deferral Elections and Receive Payments Before 12/31/05.** Any plan that is adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan, or cancel a deferral election with regard to deferred amounts that are subject to Code Section 409A, provided that (i) the amendment is adopted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includible in income of the participant in the taxable year in which the amounts are earned and vested. There is no requirement that the opportunity to terminate participation in a plan or to cancel a deferral election be granted, or if it is granted, that it must be granted to all plan participants. A termination or cancellation may be made with respect to elective or nonelective deferred compensation, and may be undertaken by the service recipient or at the election of the participant. A termination or cancellation under this paragraph may apply in whole or in part to one or more plans in which a participant participates and to one or more outstanding deferral elections the participant has made with regard to amounts subject to Code Section 409A. Q&A-20.

4. **Deferrals of 2005 Wages and Non-Performance-Based Bonuses.** Elections to defer wages and non-performance based bonuses earned on or before December 31, 2005 can be made by March 15, 2005 so long as (i) the amounts subject to the deferral have not been paid or become payable at the time of the election, (ii) the plan providing for the deferral was in existence by on or before December 31, 2004, (iii) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005 that identifies the type or amount of compensation that can be deferred and provides for the elective deferrals, (iv) the plan otherwise operates in accordance with 409A; and (v) the plan is amended to comply with Code Section 409A by December 31, 2005. Q&A-21.

5. Deferrals of 2005 Performance-Based Bonuses. Until additional guidance is issued, any performance-based bonus compensation based on services performed over a period of at least twelve months can be deferred under an election that is made no later than six months before the end of the service period. For purposes of this transition relief, the term bonus compensation refers to compensation where (i) the payment of the compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria, and (ii) the performance criteria are not substantially certain to be met at the time a deferral election is permitted. Bonus compensation may include payments based upon subjective performance criteria, but (i) any subjective performance criteria must relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and (ii) the determination that any subjective performance criteria have been met must not be made by the participant service provider or a family member of the participant service provider. Unlike the performance-based compensation rules under Code Section 162(m), there is no requirement that the bonuses be approved by a compensation committee of the board of directors (or similar entity in the case of a non-corporate service recipient) or by the stockholders or members of the service recipient. However, performance-based bonus compensation does *not* include (i) any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria is established, or (ii) any amount that is based solely on the value of, or appreciation in value of, the service recipient or the stock of the service recipient. Q&A-22.

IV. Limitations on Distributions.

A. Limited Distribution Events for NQDC Plans.

Distributions under NQDC Plans can occur no earlier than upon one of the following events:

- A participant's separation from service, and in the case of a "key employee" (as defined under the "top heavy plan" rules for qualified retirement plans) of a publicly traded company, not earlier than six months after the separation from service;
- The participant's disability (as such term is defined in the Act);
- The participant's death;
- A specified time, or pursuant to a fixed schedule, established under the NQDC Plan at the time the compensation is initially deferred;
- Upon a "change in control"; or
- Upon the occurrence of an "unforeseeable emergency."

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B. “Change in Control Events.”

1. **General Change in Control Rules.** Under Code Section 409A(a)(2)(A)(v), a NQDC Plan may permit a payment upon the occurrence of (i) a change in the ownership of the corporation, (ii) a change in effective control of the corporation, or (iii) a change in the ownership of a substantial portion of the assets of the corporation (referred to in the Notice as a "Change in Control Event"). A Change in Control Event must be objectively determinable, and any certification requirement must be strictly ministerial and not involve any discretionary authority on behalf of the individual granting the certification. A payment also will be treated as occurring upon a Change in Control Event if the right to the payment arises due to the corporation's exercise of discretion under the terms of the plan to terminate the plan and distribute the compensation deferred thereunder within twelve months of the Change in Control Event. The plan may provide for a payment on any Change in Control Event, and need not provide for a payment on all such events, provided that each event upon which a payment is provided, qualifies as a Change in Control Event. Q&A-11.

The Change in Control Event must relate to (i) the corporation liable for the payment, (ii) the corporation to whom the services are being provided, (iii) a corporation that is a majority shareholder (more than 50%) of either of (i) or (ii) above, or any corporation in a chain of majority owned corporations ending at the top of the chain with either of (i) or (ii) above. It is understood that Change in Control Events only applies to corporations. Q&A-11.

a. **Change in the Ownership of the Corporation.** A change in ownership of the corporation occurs when any person or more than one person acting as a group acquires ownership of stock that together with other stock already held by that person or group equals more than 50% of the total fair market value or total voting power of the stock of such corporation (unless the person or group already held more than 50% of the corporation before the acquisition). Q&A-12.

b. **Change in the Effective Control of the Corporation.** A change in the effective control of the corporation occurs when (i) there is an acquisition by a person or group, within a twelve-month period, of 35% of the total voting power, or (ii) a majority of the Board members are replaced by directors not endorsed by a majority of the members prior to the replacement. Q&A-12.

c. **Change in the Ownership of a Substantial Portion of the Assets of the Corporation.** A change in the ownership of a substantial portion of the assets of a corporation is an acquisition by a person or group, within a 12-month period, of a corporation's assets that have a total gross fair market value of 40% or more of the total gross fair market value of all the corporation's assets. Q&A-12.

V. Non-Acceleration of Payments.

An acceleration of the timing or schedule of any payments under a NQDC Plan is not allowed, except as provided in Notice 2005-1, and other circumstances that may be specified in future guidance. The waiver or acceleration of the satisfaction of a condition constituting a substantial risk of forfeiture applicable to a deferral of compensation, will not be an acceleration of the time or schedule of payment of deferred compensation, so long as the requirements of Code Section 409A are otherwise satisfied with respect to such deferral of compensation. Thus, if a payout occurs upon



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termination of employment after vesting, and vesting is accelerated (but presumably, not payout), there is not a prohibited acceleration. Q&A-15.

Note: This exception to the non-acceleration of payments applies to NQDC Plans subject to Code Section 409A. As described above, any attempt to accelerate vesting under a plan for which the employer is relying on the pre-2004 grandfather exception will be considered a "material modification" of such plan, causing it to be subject to, and likely fail to satisfy, Code Section 409A, and may therefore create taxation (with penalties and interest) to the affected employee.

There are a number of situations outlined in Q&A-15 of the Notice under which acceleration is also permitted, as follows:

A. Domestic relations orders.

Accelerations are permitted as necessary to fulfill a qualified domestic relations order (as defined in Code Section 414(p)(1)(B)).

B. Conflict of interest divestitures.

Accelerations are permitted as may be necessary to comply with a certificate of divestiture (as defined in Code Section 1043(b)(2)).

C. Code Section 457(f) Plans.

Accelerations are permitted from Code Section 457(f) plans to pay income taxes due upon a vesting event, provided that the amount of such payment does not exceed an amount equal to the income tax withholding amount that would have been paid by the employer if the vested amounts were wages. This is particularly helpful where taxation occurs without a distribution being paid to the employee.

D. De minimis and specified amounts.

Accelerations are permitted to allow payments of \$10,000 or less if the payment (i) is for termination of all the participant's interest in the plan (note that all account balance plans, non-account balance plans, or other plans are not treated as a single plan for these purposes), and (ii) the payments occur before the later of (a) December 31 of the calendar year of employment termination, or (b) 2½ months after the separation from service. An amendment to a NQDC Plan to permit de minimis payments may be made with respect to previously deferred amounts.

E. Payment of employment taxes.

Accelerations are permitted to pay FICA taxes due on compensation deferred under a NQDC Plan (the "FICA Amount"). Additionally, accelerations are permitted to pay the income tax at source on wages imposed under Code Section 3401 on the FICA Amount, and to pay the additional income tax at source on wages attributable to the pyramiding Code Section

3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the FICA Amount, and the income tax withholding related to such FICA amount.

VI. Deferral Election Requirements.

NQDC Plans generally must require participants to make initial deferral elections as to the time and form of distribution before the beginning of the taxable year in which the services are provided that give rise to the compensation earned. New participants are allowed to make deferral elections with respect to unearned compensation within 30 days of becoming eligible to participate in the plan. As described above, performance-based compensation must be made no later than six months prior to the end of the service period.

The Act imposes limitations on subsequent elections to change the timing and form of distributions. Subsequent elections cannot become effective until at least twelve months after the election is made. Furthermore, except for distributions attributable to an unforeseeable emergency, death or disability, the first payment covered by that subsequent election must be deferred for at least five years from when it would otherwise have been paid. Finally, a subsequent election to delay an amount payable at a specified time must be made at least 12 months prior to the date of the first scheduled payment.

VII. Funding Provisions.

Unless otherwise exempted by Treasury regulations, vested non-qualified deferred compensation will be taxable when and if funded by assets held in offshore trusts, regardless of whether such assets are available to satisfy the claims of general creditors (e.g., rabbi trusts). The offshore property restriction does not apply, however, if substantially all or the services to which the NQDC relates are performed in such offshore jurisdiction.

In addition, if a NQDC Plan provides that, in connection with a change in the employer's "financial health" (to be defined in future guidance), assets will become restricted to the payment of the non-qualified deferred compensation (through the use of a so-called "springing rabbi trust" or otherwise), such deferred compensation will be currently taxable. The tax is applicable to a NQDC Plan that provides for such an arrangement, even if the asset restriction never occurs.

VIII. Reporting Requirements.

All compensation deferred for a year (including earnings on deferred amounts), whether or not includible in gross income for that year, must be separately reported on Form W-2 or Form 1099-MISC, depending on whether the individual is an employee or non-employee, unless that individual is not someone for whom a Form W-2 or a Form 1099-MISC is otherwise required. Amounts deferred under a non-account balance plan must be reported if and when they are "reasonably ascertainable" (as defined in § 31.3121(v)(2)-1(e)(4) of the Treasury Regulations). Additional guidance is expected regarding the method of calculating the amount of deferrals to be reported. Q&A-24.

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Until further guidance is issued, no information reporting is required on amounts deferred under Code Section 409A, if the aggregate amount of such deferrals under all plans for the individual is \$600 or less. Q&A-27.

A. Requirements Applicable to Form W-2.

With respect to Form W-2:

- The total amount of deferred compensation for the year should be reported in box 12, using code Y.
- Amounts of deferred compensation includible in income under Code Section 409A (*i.e.* because of a failure to satisfy Section 409A's requirements) and in wages should be reported in boxes 1 and 12, using code Z.

If the employer furnishes an expedited Form W-2 before the issuance of additional guidance providing methods for determining the amount of deferrals or the amounts includible in income, the employer does not have to report the deferrals or the amounts includible in income on the Form W-2. However, in this circumstance, the employer must subsequently issue a corrected Form W-2 for amounts includible in income. Q&A-38.

B. Requirements with respect to Form 1099-MISC.

With respect to Form 1099-MISC:

- The total amount of deferred compensation for the year should be reported in box 15a.
- Amounts of deferred compensation includible in income under Code Section 409A (*i.e.* because of a failure to satisfy Section 409A's requirements) and are nonemployee compensation should be reported in box 7 and box 15b. Q&A-35.

C. Effective Date of Reporting Requirements.

The reporting requirements are effective for amounts actually deferred after December 31, 2004, and for earnings on those amounts. The information reporting does not apply to amounts deferred before January 1, 2005, and earnings on those amounts, notwithstanding the fact that general effective date provisions may treat such amounts as having been deferred after December 31, 2005 under the general effective date provisions. Q&A-28.

With respect to Employee Income Tax Withholding for the 2005 calendar year, amounts includible in income, but not actually or constructively received, may be treated as paid on any date on or before December 31, 2005. Amounts constructively or actually received during 2005 are considered a payment of wages when received by the employee. Q&A-32.

IX. Penalties for Non-Compliance.

If the Act's requirements are not satisfied, amounts deferred under a NQDC Plan, and all NQDC Plans subject to Code Section 409A of the affected employee in the same category (*i.e.*, account balance plans, non-account balance plans, or "other" plans, as the case may be) for the current and all preceding taxable years are taxed in the year of the violation, unless such amounts are subject to a substantial risk of forfeiture or have not previously been included in income. Such amounts are also subject to an interest charge at one percent over the underpayment rate from the time the compensation was first deferred or, if later, the time the amount was not subject to a substantial risk of forfeiture. The amount is also subject to an additional 20% tax imposed on the employee.

X. Concluding Notes.

Notice 2005-1 provided employers with significant transition relief and guidance on the application of new Code Section 409A to NQDC Plans, including arrangements that were previously not considered to be NQDC Plans. The relief provided with respect to certain SARs, certain severance plans, deferral elections made by March 31, 2005, and the requirement to amend plans by the end of 2005 is particularly appreciated. The Notice is a good beginning, but it is clear that the complexity and broad reach of the Act's provisions require further guidance from, and discussion with, the Treasury Department. The next round of guidance is expected to be issued in the first part of 2005, and will need to address distribution procedures and requirements, funding rules, guidance regarding the consequences of document failures, severance programs beyond 2005, and other critical transition rules.

If you have any questions, or need assistance in addressing the impact of the new rules, please do not hesitate to call one of the attorneys listed below.

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