

# Alert

THE EMERGING COMPANIES PRACTICE GROUP | DECEMBER 2005

WIGGIN AND DANA

*Counsellors at Law*

Dear Clients and Friends:

Our Emerging Companies and Private Equity Practice Group is issuing to our clients and friends this “Alert” which was prepared by our Employee Benefits Practice Group. We wanted to share the significant changes to Section 409A of the American Jobs Creation Act with you, which may require some immediate action. Please feel free to contact any of us if you have any questions about these changes.

## *New Rules Affecting*

### **NONQUALIFIED DEFERRED COMPENSATION PLANS**

*Suppose:*

- the board of directors of your company seeks to establish the fair market value of the company’s common stock for option grants and uses the “customary” method of valuing common stock for private companies—a discount from the preferred stock price in the last round of financing; or
- options for a departing executive are being modified to extend the post-employment period in which they can be exercised from the usual three months to a longer period; or
- the departing executive is entitled to severance or termination payments under an existing employment agreement; or
- your company is starved for cash and you agree to defer your salary for a year, when new financing is expected to come through. A year later the board wants you to consider pushing your deferral out a few more months.

Under these and other situations there may be a problem you hadn’t considered: it’s called Section 409A of the Internal Revenue Code, and it may cause you to be taxed on compensation you have not yet received, and to owe an additional 20% tax penalty.

The American Jobs Creation Act, enacted in October 2004, added Section 409A to the Internal Revenue Code. Section 409A significantly changed the federal tax rules that apply to nonqualified deferred compensation arrangements, effective January 1, 2005. The IRS recently issued 238 pages of proposed regulations providing guidance about what arrangements are subject to Section 409A, the rules applicable to deferral elections and the timing of distributions. This summary is intended to highlight some of the key issues and transition rules you need to be aware of, including some important year-end deadlines. *read more*

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## Framework

### COVERED PLANS

Section 409A applies to all nonqualified deferred compensation arrangements (NQDC plans). A NQDC plan is any plan, agreement or arrangement that provides for the deferral of compensation, including those that cover only one individual (e.g., in an employment contract) and those that cover non-employees (e.g., directors). While it probably is not surprising that the deferral of salary in the example above is considered “deferred compensation,” you might not necessarily expect the following arrangements, among others, to be considered deferred compensation:

- discounted non-statutory stock options or stock appreciation rights, or those that defer gain beyond the exercise date, or that do not specify a fixed number of shares at the date of grant;
- restricted stock units or other equity arrangements (such as phantom stock) that defer compensation beyond the vesting date;
- severance pay arrangements that pay more than two times pay (with an annual pay cap of \$210,000, as adjusted for inflation by the IRS) or that allow payments to extend more than 2 years beyond termination of employment, or that allow executives to trigger severance payments if they view themselves as constructively terminated; and
- any similar arrangement incorporated into an individual employment, retention, or severance agreement.

Of course, more traditional defined benefit supplemental executive retirement plans (SERPs) and nonqualified defined contribution plans, including ‘excess’ or ‘401(k) wrap’ plans, are also covered by Section 409A.

### EXCLUDED PLANS

Qualified plans, including 401(k) plans and defined benefit pension plans are excluded from coverage under Section 409A, as are incentive stock options and grants under employee stock purchase plans. There is also a useful exclusion for short-term deferrals—annual bonuses or other compensation amounts paid within 2-1/2 months after the close of the taxable year in which they vest. This exception can also apply to severance paid within 2-1/2 months after the end of the year of termination of employment.

### GRANDFATHERED PLANS

Section 409A does not apply to amounts that would otherwise be considered non-qualified deferred compensation under the new law, if such amounts were earned and vested prior to 2005 (grandfathered deferrals), unless the plan or arrangement under which the deferral was made is materially modified after October 3, 2004. Some employers are freezing existing plans and creating new plans for post-2004 deferrals, to avoid the possibility of subjecting pre-2005 deferrals to Section 409A and to make it easier to bring the plan into compliance for post-2004 deferrals.

## Rules

### DEFERRAL ELECTIONS

Plans subject to Section 409A must require deferral elections by the end of the year preceding the year in which participants will earn the compensation. Newly eligible participants can make prospective deferral elections within 30 days after becoming eligible to participate in the plan. Under certain circumstances participants can make deferral elections for performance-based compensation (as defined by the IRS) as late as 6 months before the end of the performance period.

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has broad experience in handling all aspects of employee benefit plans, including tax-qualified pension and profit sharing plans, non-qualified deferred compensation, employee stock ownership plans, executive compensation, long and short-term incentive compensation plans, health and welfare benefit plans, flexible benefit plans, benefit plan aspects of emerging companies, benefit plan issues in mergers and acquisitions, issues involving ERISA's complex and far-reaching prohibited transaction rules, and in restructuring medical plans for active and retired employees.

Deferrals of restricted stock units (RSU) may be made within 30 days after the RSU is granted, with respect to those RSUs vesting at least 12 months after the election.

**TIMING OF DISTRIBUTIONS AND DISTRIBUTION ELECTIONS**

The timing and form of NQDC plan distributions must either be specified in the plan or designated by the participant *at the time of deferral*. In the case of 'non-elective' plans, such as a SERP, either the executive must elect the time and form of payment at the time he or she commences participation in the plan or, alternatively, the plan must specify the time and form of payment. In addition, distributions from NQDC plans may only be made upon:

- the participant's separation from service, disability, death, or unforeseen emergency (as defined by the IRS);
- a change in the ownership or the effective control of the employer; or
- a specified time or on a fixed schedule specified under the plan at the time of the deferral.

Under these new rules, it is no longer possible to have 'unplanned' distributions, except in the case of 'unforeseeable emergencies' defined in the proposed regulations.

Distributions to a "key employee" of a public company must be delayed until 6 months after his or her separation from service, except in the event of the key employee's death or termination due to disability. "Key employee" is more broadly defined than a Rule 16(b) reporting officer.

**SUBSEQUENT ELECTIONS AS TO TIMING AND FORM OF PAYMENT**

Subsequent elections to delay commencement of benefit payments or change a form of payment are only permitted if they defer payment for at least 5 years and have a delayed effective date of at least a year.

**NO ACCELERATION OF BENEFITS**

Payments from a NQDC plan cannot be accelerated except under limited circumstances, including, among others:

- to pay an employee's share of FICA on his or her interest in the plan;
- to pay income taxes if a NQDC plan fails to meet the requirements of Section 409A;
- upon termination of the NQDC plan after a corporate dissolution, bankruptcy or change in control (the change of control exception does not apply to non-corporate entities);
- upon termination of all NQDC plans of the same type, subject to a five-year moratorium on the adoption of a new NQDC of the type terminated.

**Penalties**

If a NQDC plan fails to meet the requirements of Section 409A, all compensation deferred under the plan (including earnings) for the year of the failure and for all preceding years will be taxable to the participant in the year of the failure (to the extent not subject to a substantial risk of forfeiture). In addition, the tax is increased by interest on the "underpayment" of tax for the years that compensation which was no longer subject to a substantial risk of forfeiture was deferred, and by a 20% excise tax on the amount of compensation included in the participant's gross income as a result of the failure.

## Reporting

Starting in 2005, compensation deferred under a NQDC plan must be reported to the IRS on the participant's W-2 (or 1099 for non-employees) for the year of deferral, even if the amounts are not includible in income for the year. Deferrals required to be included in income for the year must also be reported on the participant's W-2 (or 1099) and are subject to federal income tax withholding. It is important to note, however, that Section 409A does not affect existing FICA withholding rules.

## Deadlines and Transition Relief

Section 409A applies to deferrals made in 2005 and forward. Any pre-2005 deferrals that do not qualify for grandfathering are also subject to Section 409A. For example, deferrals under an employment or other individual agreement may be subject to Section 409A even if the agreement was entered into prior to 2005, if amounts deferred were not earned and vested as of December 31, 2004. However, the IRS has given plan sponsors some deadline relief. Plans that are subject to Section 409A have to be operated in good faith compliance with the requirements on and after January 1, 2005 but they don't have to be amended to comply until the end of 2006. More importantly, there are actions that plan sponsors can take in 2005 to keep a plan from being subject to Section 409A at all. There are also actions that can be taken in 2005 and 2006 to conform covered plans to the requirements of Section 409A.

### ACTIONS TO AVOID SECTION 409A COVERAGE

These actions must be taken by the end of 2005 unless otherwise noted:

- *Rescind inadvertent material modifications adopted in 2005*  
An amendment adopted in 2005 that inadvertently caused pre-2005 grandfathered deferrals to be subject to Section 409A as a material modification can be rescinded in 2005 if no one has taken advantage of the modification. The rescission must be adopted by the end of 2005. Inadvertent material modifications adopted in 2004 cannot be rescinded under this rule;
- *Terminate the plan*  
A grandfathered NQDC plan may be terminated and all compensation deferred under it can be distributed without triggering Section 409A, if all amounts deferred under the plan are included in participants' taxable income in 2005;
- *Substitute non-discounted options and stock appreciation rights for discounted ones*  
A stock option or stock appreciation right that would otherwise be subject to Section 409A may be cancelled and reissued (retroactive to the original issue date) as a stock option or stock appreciation right that is not subject Section 409A on or before December 31, 2006, provided the holder is not compensated for the loss of the discount in 2006. The deadline is December 31, 2005 if the employer wants to provide a payment of cash, stock or other property to compensate the holder for the value of the eliminated discount (unless compensation for the lost discount would vest after 2006 and would be paid under the short-term deferral rule); alternatively, participants may exercise discounted or otherwise noncompliant options and SARs in 2005, as long as the gain is included in taxable income for 2005.
- *Cancel deferrals or terminate participation*  
An individual plan participant can terminate participation (or cancel a deferral election) in any plan subject to Section 409A in 2005, without penalty, as long

as all deferred compensation that is no longer subject to a substantial risk of forfeiture is included in income in 2005. Elections to cancel deferrals can apply to all or a portion of a participant's deferrals under the plan. An amendment to permit the termination or cancellation (if required) must be adopted and effective in 2005, but need not apply to all plan participants.

#### ACTIONS TO CONFORM COVERED PLANS TO THE REQUIREMENTS OF SECTION 409A

These actions and any others required to bring your plans into compliance with the requirements of Section 409A must be taken by the end of 2006 unless otherwise noted:

- *Eliminate election provisions linked to a qualified plan*—Section 409A generally prohibits linking a NQDC plan election as to timing or form of payments to elections under a qualified plan;
- *Add form and time of payment election options*—including the special election timing rules for performance-based compensation and subsequent election rules;
- *eliminate noncompliant form and time of payment election options*—including acceleration provisions such as “haircuts”;
- *Expressly incorporate the short-term deferral rule*—plans that can take advantage of the short-term deferral rule (e.g., annual bonus plans) should specify in the plan document that distributions will be made within 2-1/2 months following the end of the year in which the bonus or other compensation vests; doing so may exempt the compensation from Section 409A altogether;
- *Add the “key employee” distribution delay*—public companies must amend their plans to prohibit distributions to a key employee until 6-months following separation from service; and
- *Eliminate prohibited funding arrangements*—including financial health triggers and offshore trusts.

#### Conclusion

This Advisory is intended to highlight some of the most important issues that executives should consider with respect to Section 409A. The law is far-reaching and the regulations highly nuanced, particularly with respect to equity compensation. In addition, there are a number of areas in which the IRS has yet to offer much guidance. Businesses should review their employee and non-employee plans, including employment and severance agreements, to determine which may be subject to Section 409A and how to bring them into compliance, or, if it is possible or advisable to act in 2005 to avoid application of Section 409A to the arrangement.

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