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Section 409A Year-End Checklist

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Many of our clients are asking us the same question: "What do we need to do by December 31, 2005 to comply with section 409A?"

The new requirements relating to deferred compensation under section 409A of the Internal Revenue Code are effective January 1, 2005. Although the due date for amending plans to comply with section 409A is generally December 31, 2006, there are several earlier compliance dates under the proposed Treasury regulations. Plans have to be administered in compliance with section 409A as of January 1, 2005, and certain plan amendments and actions have to be made or taken by December 31, 2005. We have created the following checklist of year-end action items to assist our clients:

- Participant deferral elections for compensation to be earned in 2006 generally must be made by December 31, 2005. Later deferral elections are possible for certain types of deferred compensation such as performance-based compensation.

- A participant election to terminate participation in a deferred compensation plan or to cancel an outstanding deferral election with respect to amounts subject to 409A must be made by December 31, 2005. The deferred compensation subject to such an election must be included in the participant's income in 2005 or in the year in which the compensation vests, if later. *Any amendment to the deferred compensation plan that is necessary to permit such a cancellation or termination must be made by December 31, 2005*.

- If deferral elections for 2005 were made on or before March 15, 2005 under the special transition rule of Notice 2005-1, the deferred compensation plan may have to be modified to permit the special deferral elections. *Any amendment to the deferred compensation plan that is necessary to permit March 15, 2005 deferral elections must be made by December 31, 2005*.

- If a grandfathered plan is to be terminated, the plan termination must be completed by December 31, 2005 and all deferred amounts must be included in the participants' income in 2005. Benefits are grandfathered if they were earned and vested on December 31, 2004 under a plan in existence on October 3, 2004.

    - Any termination or amendment of a grandfathered plan must be carefully planned, in order to avoid a material modification. Any amendment of a grandfathered plan that gives a participant a right to choose between terminating participation in the plan and continuing to defer amounts will constitute a material modification of the plan and will cause the grandfathered plan to be covered by 409A retroactively to January 1, 2005.

- Stock options and stock appreciation rights (SARs) that would be subject to adverse tax consequences under Section 409A because they have an exercise price less than the fair market value of the stock on the grant date can avoid the adverse tax consequences if:

    - The options or SARs are exercised on or before December 31, 2005, or

    - The options or SARs are repriced on or before December 31, 2006 to the fair market value of the underlying shares on the original grant date, provided no post-2005 exercise occurs prior to such repricing.

  Any "make-whole payments" to a participant in connection with cancellation or repricing of an option or SAR that is subject to section 409A, whether the payment is in the form of cash, vested shares or other property, generally must be made before the end of the 2005 calendar year and included in the participant's income for 2005.

- The following stock options and SARs may also be subject to section 409A and should be reviewed and possibly modified or terminated by December 31, 2005:

    - Stock options or SARs that were modified after the date of grant. For example, an extension of the post-termination exercise period may be considered a modification.

    - Stock options or SARs granted with respect to stock of a subsidiary.

  Note that stock options or SARs that were vested and exercisable as of December 31, 2004 are not subject to Section 409A, unless they are materially modified after October 2, 2004.

- The valuation of stock for stock options or SARs granted by a privately held company should be established by a formal appraisal or an expert's report at the time of the grant, in compliance with the proposed regulations.

- "Key employees" of a public company should be identified. The proposed regulations allow key employees to be determined as of December 31, 2005, based on 2005 compensation information. The December 31, 2005 list of key employees can be used for a 12-month period starting on April 1, 2006.

- Severance agreements for employees who are leaving the company should be reviewed to determine whether they comply with section 409A or qualify for the "short-term deferral" rule that acts as an exemption from section 409A. For example, inclusion of a "good reason" termination provision in a severance agreement may trigger the requirement of a six-month payment delay for key employees.

- A designated payment date should be added to annual bonus plans. The date should generally be not later than 2½ months after the end of the fiscal year.
    - The proposed regulations include rules permitting a delay in payment for plans subject to section 409A, but these rules are only available in cases where payment deadlines are specifically set forth in the plan.
- Companies should identify all plans and agreements that are potentially subject to 409A and begin redesigning and amending the plans and agreements.

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