

Executive Compensation

Rules for Performance Rewards

A Short Overview of Equity and Deferred Cash Compensation Considerations for Discriminatory Key Executive Benefits

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Performance Awards

- The term “performance award” can be applied to any type of equity-based awards or cash awards, in which payment is conditioned upon satisfaction of performance criteria.
- These flexible awards allow for a close tie between pay and performance. There are IRS ‘rules of the road’ to be observed.

Tax Treatment of Performance Awards

- Grantee is taxed at ordinary income rates at the time of payment in an amount equal to the cash or fair market value of stock
- Company is entitled to a corresponding deduction at the time the benefit inures to the recipient

Code Section 409A Rules

- Applies to traditional nonqualified deferred compensation plans, where an executive voluntarily defers compensation, as well as supplemental executive retirement plans, excess or restoration plans, severance plans and, in some cases, stock options, stock appreciation rights and other equity-based incentive awards.

Code Section 409A Rules

The new requirements include:

- Restrictions on the timing of an initial deferred election;
- Restrictions on the earliest date for distribution;
- A prohibition on acceleration of distributions, and
- Restrictions on a participant's ability to make a subsequent election that further defers the time for distribution or changes the form of distribution.

Code Section 409A Rules

- Special exception for stock options that have an exercise price that is and that may never be less than the fair market value of the underlying stock on the date of grant and that do not contain a feature allowing the deferral of option gains
- Options that are not exempt (discounted NSOs or NSO, with deferral features) must comply or they will be subject to tax on vesting plus a 20 percent penalty tax

Code Section 409A Rules

Under Section 409A, deferred compensation can be paid no earlier than any of the following:

- Specified date in the future (or schedule of dates)
- Separation from service
- Total disability
- Death
- Change of control
- Unforeseeable emergency

Short-Term Deferrals Excluded

- 409A does not cover “short-term deferral arrangements,” defined to include arrangements where payment is made by the later of:
 - 2 ½ months after the benefits are vested;
or
 - 2 ½ months after the end of the employer’s taxable year in which the benefits become vested
- Vesting of restricted stock should constitute “short-term deferral arrangement.”

Timing of Elections

- Deferral elections must generally be made **prior to the taxable year in which the services are to be performed** and must specify the form of distribution and, if applicable, a specific time of distribution.
 - Exceptions:
 - 30-day grace period for elections by newly eligible participants
 - certain performance-based compensation arrangements can be made up to 6 months prior to the end of the performance period
 - Under the 2005 Transitional Guidance
 - Deferral Elections with respect to 2005 compensation can be made as late as March 15, 2005
 - Distribution Election with respect to 2005 Deferral Elections can be made as late as December 31, 2005

Subsequent Election Changes

- Subsequent elections to delay the timing or form of a distribution:
 - must be made at least 12 months prior to the distribution;
 - must not be effective for at least 12 months; and
 - must defer distribution for at least 5 additional years past the initial distribution date (subject to certain intervening events such as death or disability)

Acceleration of Payments

- “Haircut” provisions no longer allowed
- Payments can be accelerated only in the following circumstances:
 - Unforeseeable Emergency
 - QDROs
 - Certificates of divestiture
 - De minimis cashouts (\$10,000 or below)
 - Payment of FICA taxes on vested balances
- Permissible to accelerate payments to avoid a nonallocation year under Section 409(p)

Penalties for Violation

- All vested amounts that have been deferred under the plan (and every other NQDC plan of the same type) become currently taxable to participant
- Additional 20% penalty tax assessed on included amounts
- Participant-by-participant approach: Violation of 409A with respect to one participant does not necessarily cause violation with respect to others

Effective Date

- 409A is generally effective for:
 - Deferrals made on or after Jan. 1, 2005;
 - Amounts deferred prior to 2005 but not yet vested as of Jan. 1, 2005; and
 - Amounts deferred under a plan that has been “materially modified” after Oct. 3, 2004.
- Material modification occurs if an existing benefit or right is enhanced or a new benefit or right is added (except to amend plan to comply with 409A).
 - E.g., adding new haircut provision on 12/31/04 would constitute a material modification

Transition Relief

- Deferral elections for 2005 made until March 15, 2005
- Distribution elections with respect to 2005 deferrals may be made until Dec. 31, 2005
- Plan amendments incorporating provisions of 409A not necessary until Dec. 31, 2007
 - HOWEVER, plans must be administered in good-faith compliance with 409A effective Jan. 1, 2005

Actions to Be Taken Now

- Prepare outline of the terms of 409A-compliant plans to be followed by administrator for good-faith compliance purposes
- Determine whether to amend plans:
 - Terminate plans and distribute all benefits
 - Permit participants to cancel or amend deferral or payment elections made in 2005
 - Permit participants to cancel participation entirely
- Prepare necessary amendments by 12/31/07



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