

October 25, 2004

**Impact of New Deferred Compensation  
Legislation on SARs**

The American Jobs Creation Act of 2004 (the "Act") makes far-reaching changes in the federal tax laws that apply to nonqualified deferred compensation plans. The Act added a new section 409A to the Internal Revenue Code ("Code") that applies to amounts deferred under such plans after 2004. For the first time, the Code provides specific rules for deferral elections and distributions under nonqualified deferred compensation plans. We outline below the impact of section 409A on stock appreciation rights or "SARs."

**How SARs Work**

A SAR typically gives an employee recipient the right to an amount equal to the appreciation in a share of employer stock between the date the SAR is granted and the date it is exercised (the "spread"). This amount may be payable in shares of employer stock or in cash. Typically, the right to exercise a SAR becomes vested over a period of three or four years provided the recipient remains employed. Once a SAR is vested, (1) the employee may exercise the SAR at any time, and (2) the right to exercise will generally last until the expiration of the SAR (which may be 10 years from the date of grant if the employee continues in service). The IRS position (Rev. Rul. 80-300) has been that SARs do not cause constructive receipt.

**SARs as Nonqualified Deferred Compensation Plans**

A "nonqualified deferred compensation plan" is defined in section 409A as any plan that provides for the deferral of compensation. Many equity compensation arrangements could be said to involve a deferral of compensation and thus be subject to the new rules. While section 409A does not address the coverage of any such arrangements, the conference report for the Act provides that Congress did not intend the new rules to apply to fair market value nonqualified stock options, incentive stock options, and employee stock purchase plans. The conference report also states that Treasury "may also address in regulations issues relating to stock appreciation rights."

Treasury staff have indicated in recent weeks that they currently believe SARs will be treated as deferred compensation subject to the new rules. Interested employer groups are trying to persuade Treasury that SARs should be exempt from the new rules because, among other reasons, SARs are the economic equivalent of fair market value options.

### **SARs Vested Before 2005**

As noted above, the new rules under section 409A apply to amounts "deferred" after 2004. An amount deferred before 2005 will be grandfathered and not subject to the new rules, provided the relevant arrangement is not materially modified after October 3, 2004. Under the conference report, an amount is considered deferred before 2005 only if the amount is "earned and vested" before 2005. Thus, if all necessary services have been performed and a SAR is vested before 2005, the SAR should be exempt from the new rules, provided it is not materially modified.

### **SARs Not Vested Before 2005**

SARs that are not vested before 2005 will likely be subject to the new rules under section 409A. The new rules generally require that deferred amounts only be paid to an employee upon certain permissible distribution events (*e.g.*, separation from service or a date specified at the time of deferral). If an employee has the right to exercise a SAR at his discretion after vesting, the SAR will not meet the requirements of the new rules. This would likely result in the employee being subject to tax (plus a 20% penalty tax) on the amount of the SAR's spread when it vests.

Treasury is expected to issue transition guidance under section 409A which could provide some relief from the new rules for non-vested SARs issued before 2005. Despite the conference report provision noted above, however, Treasury does not seem inclined to accommodate SARs going forward.

### **New Equity Awards**

An employer that normally issues SARs to its employees may need to consider replacing these awards with a new form of equity compensation. An award similar to a SAR could comply with the new rules provided the award is "exercised" automatically as of a date, or multiple dates, specified on the date of grant. For example, the award could be automatically exercised (1) upon separation from service, (2) five years from the grant date, or (3) in one-third increments on each of the first three anniversaries of the grant date.

Because fair market value options should be exempt from the new rules, an employer may consider replacing SARs with grants of such options. However, an employer should carefully analyze relevant securities law, stock exchange, and accounting issues before replacing SARs with options.