An Executive's Perspective on New 409A Deferred-Compensation Rules under the American Jobs Creation Act

by David W. Powell, JD, CPA

Abstract: *Executives should be aware that the American Jobs Creation Act, which became law in late 2004, has significantly changed the rules for nonqualified deferred compensation plans, including individual contracts, bonus arrangements, stock options and stock appreciation rights, and severance pay plans. Changes limit the initial elections, funding, and distributions from such arrangements. Executives are cautioned to review every arrangement that may be covered by the new rules, consider any grandfather rules that may be available, and make appropriate decisions to change (or in some cases, to terminate) their arrangements before the end of 2005.*

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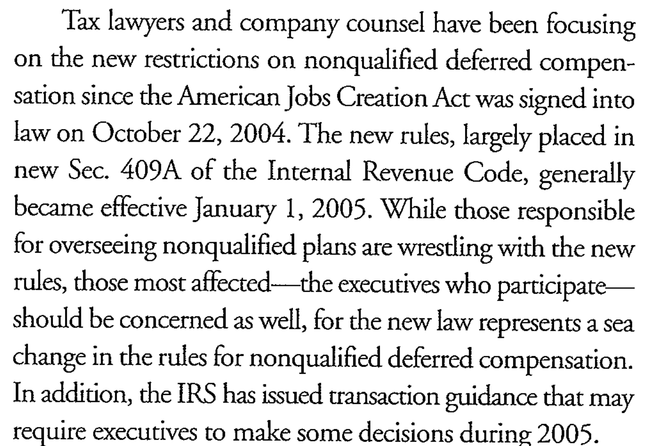

Tax lawyers and company counsel have been focusing on the new restrictions on nonqualified deferred compensation since the American Jobs Creation Act was signed into law on October 22, 2004. The new rules, largely placed in new Sec. 409A of the Internal Revenue Code, generally became effective January 1, 2005. While those responsible for overseeing nonqualified plans are wrestling with the new rules, those most affected—the executives who participate—should be concerned as well, for the new law represents a sea change in the rules for nonqualified deferred compensation. In addition, the IRS has issued transaction guidance that may require executives to make some decisions during 2005.

Background

The new rules of Sec. 409A generally apply to all nonqualified deferred compensation plans other than tax-qualified plans (such as 401(a), 401(k), 403(b) and 457(b) plans). It applies to individual contracts that defer compensation as well as to other arrangements that can have the effect of deferring compensation, including bonus programs and severance pay arrangements, although some narrow exceptions, discussed below, are provided by IRS transition guidance. The new law also applies to most stock-based compensation, including stock options and stock appreciation rights (SARs), again with some exceptions provided by the IRS in recent guidance. The new rules apply to all employers—private companies, public companies, and

governmental and tax-exempt employers. It applies to independent contractors as well as employees.

What Does an Executive Need to Do Right Now?

The first step for any executive (or the executive's counsel or tax adviser) is to review any deferred compensation arrangements the executive has that may be subject to the new laws. This involves not only arrangements thought of as plans, such as "excess plans" that provide benefits in excess of that permitted for qualified plans under the Internal Revenue Code or other types of supplemental executive retirement plans (SERPs), but any deferrals of compensation from one year to another. Individual employment contracts, bonus arrangements, severance pay arrangements, and equity-based compensation plans will all need to be reviewed for compliance with or come under an exception from Sec. 409A. Keep in mind, too, that sometimes a tax adviser looking into 409A compliance may not be aware of all nonqualified arrangements that executives of the company may have; some arrangements may be known only to certain executives.

Grandfather Rules

The new rules exempt (i.e., "grandfather") deferrals if they were both earned and vested before January 1, 2005, and then only if the plan under which they were made has not been materially modified on or after October 3, 2004. Note several important things about this grandfather. First, it will usually be advisable not to modify any existing pre-2005 nonqualified deferred compensation arrangements until the Sec. 409A implications are carefully analyzed. Second, the grandfather applies only to amounts deferred before 2004, not to the plan itself. Post-2004 deferrals under the old plan will be subject to the new rules. Third, note that amounts had to be vested as of the end of 2004. If not vested, those pre-2005 deferrals are subject to the new rules.

Specific Rules

Bonus Arrangements

The rules of Sec. 409A do not apply to a bonus if it is paid within 2½ months after the close of the later of the employer's or employee's taxable year in which the amount becomes no longer subject to a "substantial risk of forfeiture" (i.e., vested), and provided that the payments cannot be further deferred. As a general rule, this means that "plain vanilla" bonus arrangements under which a bonus is determined and then paid within a short time after year-end may not be subject to Sec. 409A. But if the bonus arrangement allows for payments to be deferred into a SERP or for delayed payout of bonuses, both of which are fairly common, the bonus arrangement may have to be modified to comply with Sec. 409A.

Stock Options, SARs and Other Equity-Based Compensation

Generally, stock options are subject to Sec. 409A unless (1) the exercise price is not less than fair market value at date of grant, and (2) the option does not include any feature for the further deferral of compensation after exercise or disposition of the option (for example, no "SERP swaps" to surrender options in exchange for SERP contributions).

Incentive stock options (ISOs) and options issued under qualified Sec. 423 plans (employee stock purchase plans) are not subject to Sec. 409A. Restricted stock will normally be subject to Sec. 83, and thus not subject to 409A. But plans providing for a future right to receive stock (i.e., restricted stock units) or other property subject to Sec. 83 may be subject to Sec. 409A.

The exception for SARs is generally limited to those issued by public companies on their publicly traded shares. Those, too, must be issued at an exercise price not less than fair market value, must pay out in stock, and must not allow any feature permitting further deferral upon exercise.

Importantly, note also that options and SARs issued before 2005 may be subject to the new rules if they were not vested as of the end of 2004.

Severance Pay

Severance pay plans are exempted from 409A during 2005 only if collectively bargained, or covering no key employees as defined in Code Section 416(i) for the top-heavy rules for qualified plans. This definition of key

employee includes up to the top 50 officers making more than $135,000, 5% owners of the company, or 1% owners of the company earning more than $150,000. In addition, the severance pay arrangement must also qualify as severance pay rather than a pension plan under the Department of Labor's definition (generally limiting the amount to two years' compensation and payment over two years, with certain exceptions) or be paid only upon involuntary termination of employment. As a result, many severance pay arrangements for top executives may be subject to Sec. 409A.

If a Plan Is Subject to Sec. 409A, Then What?

The new rules of Sec. 409A limit nonqualified deferred compensation in three ways: (1) when an election to defer is made, (2) how the plan is funded, and (3) when it pays out.

Deferral Elections

Generally, deferral elections must be made no later than the end of the year prior to the year the services were performed. There is an exception for new participants, who can elect to participate within 30 days after the date the participant first becomes eligible.

Another exception is for "performance-based compensation" measured over a period of at least 12 months, in which event the election may be made no later than six months before the end of the period. Note that this allows a later date for an election to defer an annual, performance-based bonus. Otherwise, the election would have to be made before the beginning of the performance period, i.e., the year in which the services relating to the bonus are performed. What is performance-based compensation? The IRS plans to issue additional guidance, but in the interim, it is generally compensation contingent on the satisfaction of individual or organizational performance criteria, and those criteria must not be substantially certain to be met at the time any deferral occurs. Subjective criteria are permissible, but must relate to performance and cannot be determined by the employee or a member of the employee's family.

Funding

The new law makes few changes to the area of funding. Generally, nonqualified plans cannot be funded other than through a grantor trust, also known as a "rabbi" trust, the assets of which are exposed to the claims of the company's creditors. But the new Act imposes rules aimed at preventing the use of rabbi trusts to accelerate payment or remove the creditor risk. First, the rabbi trust cannot provide that assets will become restricted to the payment of benefits upon a change in the employer's financial health. For example, the rabbi trust cannot contain a "trigger" that will convert it into a regular, nongrantor trust upon a deterioration in the employer's financial condition.

In addition, rabbi trust assets cannot be located or transferred outside of the United States unless substantially all of the services to which the deferred compensation relates are performed in the foreign jurisdiction in which the assets are located.

Distributions

The aspect of nonqualified deferred compensation plans that is arguably most restricted by the new rules is that of distributions. Generally, distributions can only occur upon

(1) separation from service
(2) disability (as specifically defined in Sec. 409A)
(3) death
(4) a specified time or pursuant to a fixed schedule specified under the plan at the time of deferral (and which thus cannot be amended)
(5) a change in ownership or effective control of corporation, or in the ownership of a substantial portion of the assets of the corporation
(6) the occurrence of an unforeseeable emergency (note that this is stricter than the rule for 401(k) plan hardship distributions, and does not permit withdrawals to purchase a house or pay educational expenses, for example)

A plan can allow acceleration of payment upon a change in ownership or control of a corporation or in the ownership of a substantial part of the corporation's assets. However, IRS guidance narrowly defines what constitutes such change in control for this purpose, and it is stricter than current rules used for other purposes in the Internal Revenue Code, such as Sec. 280G, governing the deduction of "parachute payments."

"Haircuts," or immediate distributions if the participant takes a significant (usually 10% or more) reduction in benefits, are no longer permissible. Nor are withdrawals to pay college expenses.

Plans cannot be amended to accelerate the time of payment after the deferral. Even accelerated distributions on plan termination may not be permitted (outside of a 2005 transition rule or upon a change in control).

Only a few narrow exceptions to the nonacceleration rule have been permitted by the IRS: to comply with a domestic relations order, to comply with a federal employee conflict of interest restriction, to cash out certain small sums, and to pay FICA taxes.

For 2005, "piggyback" elections, where the timing and form of SERP payments mirrors the election made by the employee with respect to the employee's qualified plan benefits, are permissible if the nonqualified plan so provided on October 3, 2004. Presumably, the IRS will issue further guidance on this for years after 2005.

Further deferral of the time of payment is also severely restricted. Any election to further defer payment must be made at least 12 months before the date the payment would otherwise be made, and the deferral must be for a period of at least five years from the date payment would otherwise be made. This rule is intended, among other things, to restrict the application of so-called "rolling risks of forfeiture."

As a result of these rules, executive deferred compensation in the future will have to be much less flexible as to when the executive will receive his or her benefits. In many cases, plans will need to be amended to "hard wire" the time and form of distributions.

Decisions to Be Made in 2005

One exception to the rule that deferral elections must be made prior to the year the services are performed, for 2005 only, is that an election that could have been made in 2004 with respect to 2005 deferrals under the terms of the plan as in effect on December 31, 2004, could be made prior to March 15, 2005.

Executives reviewing their situations in 2005 and considering the changes that may have to be made are also not necessarily locked into their current deferral arrangements. IRS guidance allows a plan to be amended to permit participants to terminate participation in a plan or cancel a deferral election (in whole or in part) and have amounts that otherwise would have been deferred in 2005 paid and includible in income in 2005.

Otherwise, though, plans subject to Sec. 409A must comply with the rules in operation, subject to a reasonable, good faith interpretation of the statute in 2005, and be amended to comply in form by the end of 2005.

Consequences of Failure to Comply with 409A

Almost all of the tax consequences of failure to comply with 409A will fall on the executive. Those include the amount being included in the executive's gross income in the year of failure (or when not subject to a substantial risk of forfeiture, i.e. vested, if later), plus a 20% penalty and interest from the year of deferral (or year of vesting, if later) to the year of inclusion. Not only should these consequences of failure be sufficient to focus the attention of any executive on the importance of complying with Sec. 409A, they may also give rise to executives seeking indemnification clauses in future employment agreements, at least to the extent the failure is not the executive's fault.

Conclusion

The American Jobs Creation Act has imposed significant restrictions on nonqualified executive compensation. Executives should closely review their compensation arrangements in 2005 for compliance with Sec. 409A. Significant changes, particularly to distribution rules, will likely be required. Significant tax and penalties could result from failure to do so by the end of 2005. Executives should also watch closely for further IRS guidance on Sec. 409A throughout the year. ■

David W. Powell, JD, CPA, is a principal with the Groom Law Group in Washington, DC, a law firm specializing in employee benefits. Mr. Powell is a frequent writer and speaker on the subject of nonqualified deferred compensation for executives. He is a graduate of the University of Texas School of Law. Mr. Powell can be reached at dpowell@groom.com.