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IRS Transition Guidance on Deferred Compensation Legislation

The IRS recently issued eagerly-awaited preliminary guidance on the rules for nonqualified deferred compensation plans recently enacted as part of the American Jobs Creation Act of 2004 (the "Act"). The guidance comes in the form of Notice 2005-1 (Dec. 20, 2004) and provides generous and flexible transition relief for most arrangements, typically extending to the end of 2005. The Notice also provides definitions of key terms under the Act, including "nonqualified deferred compensation plan." The Notice is the first of what is expected to be several guidance items on the new rules under Code section 409A.

Much of the information in the Notice was contained in the Act or the conference report on the Act. Our focus below is on the new guidance in the Notice – primarily the transition relief and definitions of key terms.

I. Transition Relief

A. Good Faith Compliance Period/Plan Amendments

Plans are not required to be amended to conform to Code section 409A until December 31, 2005. However, they must be operated in accordance with the Notice and section 409A in 2005. For issues not addressed in the Notice, plans should be operated based upon a reasonable, good faith interpretation of the requirements of section 409A and its purpose, including consideration of the legislative history. If future guidance is less favorable than the Notice, the IRS anticipates that the new position will be applied only prospectively with adequate transition relief to allow plans to be modified accordingly. [Q&A-19(a)]

B. Deferral and Payment Elections

In general, for plans in existence on or before December 31, 2004, deferral elections may be made as late as March 15, 2005, with respect to compensation for services performed on or before December 31, 2005, so long as the amounts have not been paid or become payable at the time of election. Importantly, the Notice provides that the availability or making of such an election will not trigger constructive receipt under Code section 451. [Q&A-21] Plans also may be amended to provide for new payment elections with respect to amounts that are subject to section 409A and deferred before the election so long as the plan is amended and the election is made on or before December 31, 2005. [Q&A-19(c)] Such an election will not be treated as a change in the form or timing of payment under section 409A.

C. Termination/Cancellation of Outstanding Elections

Plans adopted before December 31, 2005 may be amended by December 31, 2005 to permit participants during 2005 to terminate participation in the plan or cancel an outstanding deferral election with respect to certain amounts subject to section 409A. Such amounts must be includible in income in the year the amounts are "earned and vested" (as defined for purposes of the effective date). The Notice provides very flexible rules for implementing this relief. Elections may be granted to participants on a selective basis and may be chosen by the employer or the participant. Further, the elections may apply in whole or in part to one or more plans or outstanding deferral elections, and may provide for a partial cancellation resulting in a lower amount of deferrals. Again, the Notice provides that neither the availability nor making of such an election will trigger constructive receipt under Code section 451. The plan aggregation rules described below (in Part II.A.2) do not apply for these purposes. [Q&A-20]

D. Performance-Based Compensation

The general rule under section 409A is that a deferral election must be made in the taxable year before the year in which services are performed. However, an exception applies to "performance-based compensation" earned over a period of at least 12 months. An initial election to defer such compensation may be made as late as 6 months prior to the end of the service period. Until additional guidance is issued, the Notice provides that the special election timing rules will apply to "bonus compensation" where (1) the payment or amount of the compensation is contingent upon the satisfaction of organizational or individual performance criteria (including subjective criteria in certain circumstances), and (2) the performance criteria are not substantially certain to be

satisfied at the time of election. IRS anticipates issuing further guidance setting forth requirements for compensation to qualify as performance-based compensation, and suggests that those requirements will be more restrictive than the requirements in the Notice.

The Notice also provides generally that compensation that is "based solely on the value of, or appreciation in the value of, the employer or the stock of the employer" will not qualify as performance-based compensation. [Q&A-22] Thus, it appears that options, restricted stock and other equity-based compensation that vests based solely on the person's remaining in service through a certain date would not be considered performance-based compensation for these purposes.

E. SERP Distribution Elections

Many existing supplemental defined benefit plans or "SERPs" provide that a participant's benefits will be distributed at the time and in the manner that the participant elects for benefit distributions under the related tax-qualified retirement plan. This type of distribution provision normally will not comply with section 409A (and also raised constructive receipt issues under prior law). Nevertheless, the Notice provides special temporary relief for nonqualified plans with this type of distribution provision. Specifically, for periods ending before 2006, an election as to the timing and form of a payment that is controlled by a participant's payment election under a qualified plan will not violate section 409A if the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified plan as of October 3, 2004. [Q&A-23] Thus, distributions of both grandfathered and post-2004 accruals under such a plan may commence in 2005 in accordance with the terms of a participant's election under a qualified plan. We understand this also means that payments for "key employees" in this situation are not subject to the required 6-month delay under Code section 409A.

F. Effective Date/Grandfather Rules

Section 409A is generally effective as to (1) amounts deferred after 2004, and (2) amounts deferred before 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. Section 409A applies to earnings on deferred amounts only to the extent that such deferred amounts are subject to section 409A.

For purposes of the effective date, the Notice provides that an amount is considered deferred before 2005 if (1) the employee has a legally binding right to be paid

the amount, and (2) the right to the amount is "earned and vested" before such date. A right is considered "earned and vested" only if it is not subject to either a substantial risk of forfeiture, as defined in the Code section 83 regulations, or a requirement to perform further services. Thus, a requirement that the employee perform additional services after 2004 could cause an amount to be considered unvested for purposes of the effective date and grandfather rule, even if the future performance would not be considered "substantial services" for purposes of Code section 83 (e.g., a few months). A very limited exception applies where the requirement of future services extends only through the end of the payroll period which includes December 31, 2004. [Q&A-16]

G. Calculation of Grandfathered Amount

The Notice provides guidance on the determination of the amount of compensation deferred before 2005 (i.e., the grandfathered amount, which remains subject to prior law rules) for account balance plans, nonaccount balance plans, and equity-based compensation plans. The terms "account balance plan" and "nonaccount balance plan" are based upon the definitions in the FICA tax regulations for deferred compensation plans under Code section 3121(v)(2).

- **Account Balance Plans:** The grandfathered amount is the portion of the participant's account balance as of December 31, 2004 that is earned and vested, plus subsequent earnings on this amount.

- **Nonaccount Balance Plans:** The grandfathered amount is the present value as of December 31, 2004 of the earned and vested benefit to which the participant would be entitled if the participant voluntarily terminated services without cause on that date and received a full payment of benefits on the earliest possible date allowed under the plan. The plan must use the actuarial assumptions as set forth in the plan if they are reasonable; otherwise, reasonable assumptions must be used. (For these purposes, the aggregation rule described below does not apply.) Increases in potential benefits due to compensation increases after 2004, subsequent eligibility for an early retirement subsidy or other factors may not be taken into account in determining the grandfathered amount. However, increases in the present value of the participant's benefit as of December 31, 2004 due solely to the passage of time (e.g., because of the shortening of the discount period) are grandfathered.

- **Equity-Based Compensation:** The grandfathered amount is the earned and vested amount of the payment available to the participant on December 31, 2004 (or that would be available if the right were immediately exercisable), net of any exercise price. An increase in the amount payable under a stock option, stock appreciation right, or other equity-based compensation due to appreciation in the underlying stock after 2004 is also grandfathered. [Q&A-17]

H. Material Modifications

1. What Are Material Modifications?

In general, a material modification occurs if a benefit or right existing as of October 3, 2004 is enhanced, or a new benefit or right is added – whether pursuant to a plan amendment or the employer's exercise of discretion under the terms of the plan. A plan amendment or the exercise of discretion under the plan terms to enhance an existing benefit or right or add a new benefit or right is considered a material modification even if the enhancement or added benefit would be permitted by section 409A (e.g., adding an "unforeseeable emergency" distribution option). The Notice also confirms that the acceleration of vesting of a benefit to a date on or before December 31, 2004 is a material modification.

The adoption of a new arrangement or grant of an additional benefit is presumed to be a material modification. The presumption can, however, be rebutted by demonstrating that the action is consistent with the employer's historical compensation practices.

The grant of an additional benefit under an existing arrangement that consists solely of a deferral of additional compensation not otherwise provided as of October 3, 2004 is treated as a material modification only as to the additional deferral of compensation. However, the plan must explicitly identify the additional deferral and provide that it is subject to section 409A in order to prevent the remaining amounts from becoming subject to the new rules.

2. What Are Not Material Modifications?

An employer's exercise of discretion over the time or manner of payment is not a material modification to the extent such discretion is provided under the plan as of October 3, 2004. It also is not a material modification to change an investment option, or

to add a commercially available investment option. Amending a plan or arrangement to stop future deferrals is not a material modification.

Importantly, amending an arrangement on or before December 31, 2005 to terminate it and distribute amounts deferred thereunder also is not a material modification, provided that all deferred amounts are included in income in the year in which the termination occurs. Thus, an employer should be able to unilaterally terminate an arrangement in 2005 and distribute deferred amounts to participants without risking adverse treatment under section 409A. Whether the Notice authorizes a "partial termination" or individual negotiations with participants regarding whether to terminate and distribute is unclear and could raise constructive receipt issues in any event. It remains to be seen whether future guidance will provide any relief from section 409A for distributions made pursuant to plan terminations occurring after 2005, other than in the case of a change in control (as described below).

The plan aggregation rules described below do not apply for purposes of determining whether a material modification has occurred. [Q&A-18]

II. Definitions of Key Terms

A. Nonqualified Deferred Compensation Plan

A "nonqualified deferred compensation plan" subject to section 409A is defined as any plan that provides for the deferral of compensation, with certain exceptions for tax-favored retirement plans and certain welfare-type plans. The Notice provides that a plan provides for a deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, an employee (or other service provider) has a legally binding right during a year to compensation that has not been actually or constructively received, and that is payable in a later year. [Q&A-4(a)] The definition is substantially identical to the one in the FICA tax regulations on deferred compensation plans under Code section 3121(v)(2). Like the FICA rules, deferred compensation is not limited to voluntary deferrals of compensation, but includes SERPs and similar programs that automatically cover eligible persons.

1. Short-Term Deferrals

The Notice provides a helpful exception for "Short-Term Deferrals," although the IRS notes that future guidance may scale back this exception from the reach of section 409A. Specifically, a deferral of compensation does not occur under a plan if – absent an election to otherwise defer a payment to a later period – the terms of the plan at all times

require payment, and an amount is actually or constructively received by an employee, by the later of:

- the date that is 2½ months after the end of the employee's taxable year in which the amount is no longer subject to a substantial risk of forfeiture (see discussion below); or

- the date that is 2 ½ months after the end of the employer's taxable year in which the amount is no longer subject to a substantial risk of forfeiture. [Q&A-4(c)]

Under this Short-Term Deferral exception, an amount paid to an employee by March 15th of the year following the year in which the amount vests generally will not be considered to involve deferred compensation, and section 409A will not apply. The Notice provides an example under which a bonus payable shortly after the end of a three-year performance period would generally not be subject to section 409A.

2. Plan Aggregation Rules

A "plan" is defined under the Notice as any agreement, method, or arrangement, even if it applies only to one person or individual. The Notice provides that each individual participant is treated as having his own plan for purposes of section 409A, and that all compensation deferred for a participant under similar plans maintained by one employer will generally be treated as deferred under one plan. For this purpose, plans in each of the following categories will be aggregated and treated as one plan:

- account balance plans under the Code section 3121(v)(2) regulations (i.e., defined contribution-type plans);

- nonaccount balance plans under the Code section 3121(v)(2) regulations (i.e., defined benefit-type plans); and

- all other plans (e.g., equity compensation awards subject to section 409A). [Q&A-9]

A significant effect of this plan aggregation rule is that if a participant experiences a violation of section 409A under one plan (e.g., an impermissible payout), amounts deferred under that plan – as well as under all other plans in the same category covering that person – will be subject to adverse tax treatment under section 409A. (While not addressed in the Notice, Treasury staff continue to informally confirm that, as indicated

in a footnote to the conference report, this adverse tax treatment will only apply to deferred amounts that are subject to section 409A, i.e., the adverse treatment will not apply to grandfathered amounts in the same plan.) On the plus side, this also means that other participants in the plan that made the noncomplying distribution in operation will not be adversely affected.

As noted above, the plan aggregation rule does not apply for purposes of certain other rules as specified in the Notice (e.g., material modification rules).

3. Severance Plans

A plan that provides "severance pay" and is either (i) collectively bargained or (ii) covers no "key employees" (as defined in Code section 416(i)) is not required to meet the requirements of section 409A in 2005, as long as the plan is amended to comply with section 409A by December 31, 2005. To be considered "severance pay" for purposes of the transition relief, the arrangement must either satisfy the conditions in the DOL severance pay safe harbor (29 CFR § 2510.3-2(b)(1)(i)-(iii)) or pay benefits only upon involuntary termination of employment. [Q&A-19(d)] The Notice requests comments regarding the application of section 409A to severance plans and whether to exclude specific types of severance plans from coverage under section 409A.

4. Equity Compensation Arrangements

Except as otherwise provided in the Notice, stock options, stock appreciation rights ("SARs"), and other equity-based compensation constitute deferred compensation and will be subject to section 409A. [Q&A-4(d)(i)] Fortunately, the Notice confirms that, as indicated in the legislative history, incentive stock options and employee stock purchase plans are not subject to section 409A because they are subject to separate rules under the IRS Code. The Notice also provides that there is no deferral of compensation merely because the value of property (e.g., restricted stock) is not includible in income in the year of receipt under Code section 83. We address below exemptions under the Notice for a few other common types of equity-based compensation.

a. Nonqualified Stock Options

The Notice provides an exemption from section 409A for a nonqualified stock option if:

(1) the option's exercise price may never be less than the fair market ("FMV") of the shares on the date of grant;

(2) the receipt, transfer, or exercise of the option is subject to tax under Code section 83; and

(3) the option does not include a deferral feature. [Q&A-4(d)(ii)]

Thus, discounted options and options or plans that allow the grantee to defer the receipt of shares otherwise deliverable upon exercise will be subject to section 409A. To determine whether an option was issued with a discounted exercise price, the Notice provides that any reasonable valuation method may be used to determine the FMV of the underlying shares on the date of grant. The IRS asks for comments on appropriate techniques for valuing shares that are not traded on an established securities market.

The Notice expresses concern with exempting options (or SARs) with an employer repurchase right, particularly rights that permit repurchase for other than the FMV of the shares. Future guidance may limit the exemption from section 409A for such options.

b. SARs

While the Notice states that SARs normally will be subject to section 409A, the IRS provides exceptions to this general rule for both publicly-traded and private companies. First, the Notice exempts SARs issued by a company whose shares are traded on an established securities market if:

(1) the exercise price may never be less than the FMV of the shares on the date of grant;

(2) only shares may delivered upon exercise; and

(3) the SAR does not include a deferral feature. [Q&A-4(d)(iv)]

This exception will allow public companies to continue to issue stock-settled SARs (but not cash-settled SARs) without complying with section 409A. However, the Notice indicates that if the SAR provides for the employer to purchase the shares delivered to the grantee upon exercise of a SAR this exception may not be available.

For SARs that do not meet the first exception – generally, private company and cash-settled SARs – the Notice provides an additional exception that applies until further guidance is issued. Specifically, the amount received upon exercise or cancellation of a

SAR granted under a pre-existing plan, including SARs granted after 2004, will not be treated as subject to section 409A if:

(1) the exercise price may never be less than the FMV of the shares on the date of grant; and

(2) the SAR does not contain a deferral feature. [Q&A-4(d)(iv)]

Importantly, the Notice also states that a SAR that contains a fixed payment date (e.g., 3 years from grant) generally will comply with section 409A. Such a SAR presumably also could allow the grantee to choose the date of exercise, while providing that the exercise proceeds (and earnings thereon) would be distributed as of the fixed payment date.

The Notice reflects IRS concerns with exempting SARs issued by private companies from section 409A and requests comments generally on exempting SARs. However, if future guidance on SARs (or options) is less favorable, the IRS expects the guidance will apply prospectively and will provide transition relief to modify SARs.

c. Restricted Stock Units

A restricted stock unit ("RSU") under which a share is issued to a grantee on the date the RSU vests should not be subject to section 409A under the Short-Term Deferral exception described above, unless it contains an elective deferral feature.

d. Transition Relief for Options and SARs

In addition to the general transition relief described above, the Notice provides the following special rules for amendments to options and SARs before 2006:

- It is not a material modification to replace an option or SAR otherwise subject to section 409A with an option or SAR that would have been exempt from section 409A had it been awarded on the original date of grant of the replaced option or SAR, if certain requirements are met. For example, an option originally issued with a discounted exercise price could be amended to eliminate the discount and become exempt from section 409A. Similarly, a SAR not meeting the requirements for exemption could be converted to an option or SAR that would be exempt from section 409A. [Q&A-18(d)]

- An option or SAR that is subject to section 409A may be amended to provide for, or to permit grantees to elect, fixed payment terms consistent with section 409A, without meeting the general rules for a change in the form and timing of payment under section 409A. [Q&A-19(c)]

B. Substantial Risk of Forfeiture

A key term under section 409A, and under the Short-Term Deferral exception announced in the Notice, is "substantial risk of forfeiture." Rather than incorporate the definition of this term under Code section 83 and the regulations thereunder, a brief stand-alone definition was included in section 409A. The Notice expands on this definition, providing that compensation will be considered subject to a substantial risk of forfeiture (a "SRF") if:

- entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation; and

- the possibility of forfeiture is substantial. [Q&A-10]

The Notice makes clear that so-called "rolling risks of forfeiture" – such as an SRF added to an arrangement after the relevant service period begins, and any extension of the period during which the SRF applies – will be disregarded in making this determination. Further, an SRF will not exist merely because an employee's right to an amount is conditioned on compliance with a non-compete agreement.

III. Other Issues

A. Distributions Upon a Change in Control

Under section 409A, a distribution is permissible upon a change in control ("CIC") only to the extent provided by IRS rules. The Notice provides the following rules with respect to distributions upon a CIC:

- A distribution may be made upon a CIC that is objectively determinable; any required determination that an event constitutes a CIC must be strictly ministerial and not involve any discretionary authority.

- A distribution may also be made upon a CIC if the payment is made pursuant to a corporation exercising its discretion under a plan to terminate the plan and make distributions within 12 months of a CIC.

- To constitute a CIC as to a participant, the CIC must relate to (1) the corporation for which the participant is providing services at the time of the CIC, (2) the corporation that owes the participant the deferred compensation, or (3) a corporation that is a majority shareholder in a chain or corporations ending at a corporation described in (1) or (2).

- The definition of a CIC largely follows that under the golden parachute regulations under Code section 280G. The definitions differ on, among other things, the level of stock and asset acquisitions that will result in a CIC. Generally the Notice requires higher thresholds for a CIC to occur than under section 280G (and typical plan provisions). [Q&A-11 to Q&A-14]

B. <u>Exceptions to Prohibition on Acceleration of Payments</u>

Under section 409A, a plan generally may not permit accelerated payments, but the guidance provides certain exceptions, including:

- acceleration of time or schedule merely by reason of a waiver or acceleration of a substantial risk of forfeiture by the service recipient (e.g., the employer or plan sponsor),

- acceleration due to a domestic relations order,

- acceleration to comply with a federal employee conflict of interest restriction,

- a provision to pay taxes upon vesting under a § 457(f) plan, provided that the amount does not exceed the income tax withholding that would have occurred had the vested amount been paid as wages,

- a provision to cash-out a minimum specified amount under the plan if (i) the payment terminates the participant's interest in the plan, (ii) the payment is made on or before the later of December 31 of the calendar year in which occurs the participant's separation from service or 2 ½ months after the

participant's separation from service, and (iii) the amount is not greater than $10,000, and

- acceleration of an amount necessary to pay FICA taxes.

The Notice clarifies that an acceleration of vesting will not be treated as an acceleration of payment.

C. Reporting and Withholding Issues

The reporting requirements under section 409A apply only to amounts "actually deferred" on or after January 1, 2005, and earnings thereon. Therefore, amounts that were deferred but unvested as of December 31, 2004 (and earnings thereon) are not subject to any special reporting rules, even though they are subject to section 409A. Although the Notice provides helpful guidance on several items relating to reporting and withholding, it does not address some of the major reporting questions arising from the Act, such as:

- how to calculate the amount of deferrals required to be reported for a year;

- how to calculate the amounts included in gross income under section 409A; and

- whether and how to report or withhold the 20 percent additional tax and interest imposed for failure to meet section 409A.

The Notice does include guidance on the following reporting issues, although some of it is transitional:

- **Deferrals for Employee:** As provided in IRS Announcement 2004-96, 2005 deferrals for an employee that are subject to section 409A should be reported in box 12 of Form W-2, using the new code Y. Until future guidance is issued, if the aggregate deferrals for an employee during a year under an employer's nonqualified deferred compensation plans are less than $600, they need not be reported.

- **Employee Taxable Income:** Amounts includable in an employee's income under section 409A should be reported in both boxes 1 and 12 (using new code Z) of Form W-2. For 2005, income tax withholding on amounts that have not been actually or constructively received (e.g., income resulting

from a failure to comply with section 409A) can be paid on any date before 2006.

- **Deferrals for Non-employee:** Deferrals for a non-employee (e.g., directors or consultants) should be reported in box 15a (new for 2005) of Form 1099-MISC, unless a Form 1099-MISC is not required to be filed for the non-employee (e.g., an independent contractor earning less than $600).

- **Non-employee Taxable Income:** Amounts includable in a non-employee's income under section 409A should be reported in boxes 7 and 15b of Form 1099-MISC. Amounts reported in box 7 are subject to self-employment tax, even if resulting from a failure to satisfy section 409A. [Q&A-24 to Q&A-38]

D. Miscellaneous

The Notice also addresses the application of section 409A to the following types of arrangements:

- arrangements covered by Section 457;

- arrangements between a partnership and a partner; and

- arrangements involving service providers that are engaged in a trade or business.

IV. Concluding Observations

The generous IRS transition relief is very welcome, particularly the relief for SARs, the ability to make 2005 deferral elections before March 15, 2005, the ability to cancel elections or terminate participation during 2005, and the ability to defer making plan amendments until the end of 2005. The guidance illustrates, though, just how sweeping and complex the new law is.

The IRS requests comments on many of the issues addressed in the Notice, including the application of section 409A to SARs and severance plans. In addition to further guidance on the issues in the Notice, the IRS will need to address the new deferral election and distribution election procedures, as well as the funding rules, under section 409A. The next round of guidance is expected in the first half of 2005.

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Please call one of the following, or the firm attorney you regularly contact, if you have any questions about the Act, the Notice, or their impact on your executive compensation arrangements.

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