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Deferred Compensation Tax Guidance Delivers Relief: Employers Need to Respond in 2005

By J. Mark Poerio and Eric R. Keller

On December 20, 2004, the Treasury Department and the IRS jointly issued Notice 2005-1, and thereby presented their initial guidance on the newly-enacted tax law focused on nonqualified deferred compensation. The widely-anticipated Notice takes the form of detailed questions and answers that focus on the most pressing issues arising under new Internal Revenue Code Section 409A.[1] This section accelerates taxation and imposes a 20% additional tax on deferred compensation arrangements that do not conform with Section 409A's restrictions on deferral elections, payment elections, distributions, and other rules.

In the summary that follows, the term "Plan" refers to any plan, arrangement, or agreement that is subject to Code Section 409A,[2] and the term "Executive" refers to any employee, director, or other service provider[3] who participates in a Plan.

Deadlines

January 1, 2005 is the effective date of Section 409A. Plans must operate in "good faith compliance" with its terms to avoid triggering Section 401A penalties.

March 15, 2005 is the deadline by which Executives must make deferral elections for 2005 deferrals.[4]

December 31, 2005 is the deadline by which:

- Noncompliant Plans must be amended to conform with Section 409A, or be terminated to avoid Section 409A penalties.
- Plan sponsors may permit Executives to terminate Plan participation and receive a taxable distribution of their Plan benefits.[5]
- Executives and directors must make any elections that their employers allow with respect to (i) terminating plan participation, (ii) wholly or partially[6] canceling deferral elections for 2005, and (iii) making deferral elections for 2006 compensation.

Scope of Section 409A

The Notice states that Section 409A applies to any plan, arrangement, or agreement under which an Executive has a legally binding right in one year to collect compensation in a future year.[7] Some relief comes through an exemption from Section 409A for payments that occur within 2-1/2 months after the end of the first taxable year in which the Executive's right to the benefit is no longer subject to a substantial risk of forfeiture. For this purpose, the taxable year is that of the Executive or the employer, whichever is later.[8] A substantial risk of forfeiture exists if a condition for the compensation relates to:

> *the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value, or liquidity event).*[9]

Substantial risks of forfeiture cannot be added after the service period begins (e.g., by extending the vesting date), nor is the requirement that an Executive refrain from the performance of services (e.g., honor a non-compete) a substantial risk of forfeiture.

Changes in Corporate Control

Section 409A permits Plans to make distributions following a change in control, but the statute leaves it to the Internal Revenue Service to establish what constitutes a "change in control." Q&As 11 to 14 in Notice 2005-1 provide welcome guidance on this subject. They authorize Plan distributions upon events that are "objectively determinable" to be "Change in Control Events" within the meaning of the Notice. In general, these events involve:

- a 50% or more change in corporate ownership,
- a change in effective control (through a 35% or more acquisition of voting power or a hostile

election of a majority of directors over a 12-month period), or

- a change in ownership of a substantial portion of corporate assets (40% or more during a 12-month period).

Certain SARs Exempted

Section 409A had threatened to make typical stock appreciation rights ("SARs") an endangered species. Notice 2005-1 breathes fresh life into SARs by exempting them from Section409A if:

1. the SARs relate to publicly-traded shares of the employer's stock;

2. the SARs' exercise price is at or above the fair market value ("FMV") of the underlying shares on the grant date;

3. the SARs must be settled only in shares not cash; and

4. the SARs do not permit deferral of income after exercise.[10]

Outstanding SARs and Stock Options

Notice 2005-1 exempts from Section 409A "until further guidance is issued" SARs granted before October 3, 2004 if (i) their exercise price was not less than FMV on the grant date, and (ii) they do not permit deferral of income after exercise.[11]

On the other hand, Notice 2005-1 confirms that Section 409A applies to stock options granted or first vesting after 2004 if their exercise price was below FMV on the grant date. Those concerned about past determinations of FMV received some relief in Notice 2005-1, in that it sanctions "any reasonable valuation method."[12]

The transition rules within Notice 2005-1 apply to SARs and below-market stock options that vest after 2004, and are therefore subject to Section 409A. During 2005, Section 409A will not be violated if SARs and stock options are:

- Amended to conform with Section 409A, e.g., through addition of fixed payment terms allowable under Section 409A. Employers may permit Executives to select the fixed payment terms.[13]
- Replaced with new, economically equivalent grants.[14] The replacement grants may be stock options or SARs, and may either comply with Section 409A or be designed to be exempt from Section 409A.

Restricted Property

Restricted stock or other restricted property governed under Code Section 83 is not deferred compensation to which Section 409A applies if the property is delivered to the Executive no later than when the substantial risk of forfeiture restrictions lapse.[15]

Other Guidance Within the Notice

Notice 2005-1 also provides guidance on the following Section 409A issues:

Grandfathering[16]

Section 409A does not apply to deferred compensation that accrued and vested before January 1, 2005. Notice 2005 describes grandfathered amounts as follows:

For Non Account Balance Plans—the discounted present value of the benefit payable to the Executive if his or her employment terminated without cause on December 31, 2004 (increased annually thereafter to reflect the shortening of the discount period through the passage of time).

For Account Balance Plans—the earned and vested balance on December 31, 2004.

For Equity Awards—the earned and vested rights as of December 31, 2004.

Note: Post 2004 earnings on grandfathered amounts, including stock appreciation on equity awards, are also grandfathered.[17]

Performance-Based Compensation

Section 409A permits performance-based compensation to be deferred if an otherwise untimely deferral election is made at least six months before the end of the compensation program's service period. Notice 2005-1 generally defines "performance based compensation" as bonus compensation that "is contingent on the satisfaction of individual or individual performance criteria . . . [that are] not substantially certain to be met at the time a deferral election is permitted."[18]

Accelerated Payment

Notice 2005-1 allows Plans to make otherwise non-Section 409A compliant premature distributions under limited circumstances such as (i) to honor domestic relations orders, (ii) to pay taxes due under 457(f) plans or employment taxes, such as FICA taxes, and (iii) to make certain small benefit cash-outs of less than $10,000.[19]

Partnership Interests

Section409A could apply to partner compensation. Notice 2005-1 exempts grants of partnership interests and certain other partnership payments from Section 409A until further guidance is given.[20]

Severance Plans

It is unclear whether Section 409A will apply to severance plans. Notice 2005-1 states that severance plans that are collectively bargained or do not cover key employees do not need to comply with Section 409A in 2005 provided they are amended by December 31, 2005 to comply with Section 409A if subject to it for future years.[21]

Qualified Plan Mirror Distributions

Many nonqualified plans, particularly SERPS that top up qualified defined benefit plan benefits, provide that distributions will be made in a way that mirrors qualified plan distributions both in form and timing. Because qualified plans typically allow distribution elections to be made shortly before benefits commence, such mirror distribution provisions generally will be made too late to comply with Section 409A. Notice 2005-1 permits such mirror provisions, to the extent in place by October 3, 2004, to continue to be applied through the end of 2005.[22]

Material Modifications

Pre-Section 409A grandfathering would be lost if the Plan is materially modified after October 3, 2004. Notice 2005-1 defines this as the enhancement of existing benefit or addition of new benefit, such as accelerating vesting into 2004. However, changes to the designated rate of return on Plan investments, and making grants in 2004 consistent with past practice are not material modifications.[23]

Information Reporting

Section 409A requires special Internal Revenue Service reporting for years after 2004.[24] See Q&As 34 to 37, which explain how to report non-employee deferred compensation.

Wage Withholding

For 2005 and future years, employers must file a Form W-2, or 1099 for non-employees, to report any amounts that are includible in income as the result of Section 409A.[25] See Q&A-38 regarding expedited W-2 reporting for terminated employees.

What to Expect

On December 20, 2004, two staff attorneys of the Treasury Department participated in a tele-conference about Notice 2005-1. They indicated that the Treasury Department is unlikely to issue further written Section 409A guidance before the middle of 2005.

As a result, we generally suggest that clients begin in early 2005 to evaluate their Section 409A issues. This will permit appropriate consideration of transitional Plan amendment or termination of alternatives, and will enable employers to contact Executives in a well-considered manner before the March 15, 2005 deadline. This is the date by which they generally must make deferral elections for 2005.

No one should expect immediate, easy answers to all issues arising under Code section 409A. Plan sponsors should proceed in a conservative manner that minimizes the risk of triggering premature income recognition and the significant additional tax penalties under Section 409A.

Please feel welcome to contact Ethan Lipsig, Mark Poerio, Stephen Harris or Eric Keller with any questions about Code Section 409A and its effect on your nonqualified plans, arrangements, and individual agreements.

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Notes

1. For a general discussion of Code Section 409A, see our client alert titled "Congress Tightens Deferred Compensation Tax Laws" (reproduced at http://xpay.net/NQ409aSum.htm).
2. Q&A-9 states that Section 409A generally will be applied as if separate Plans are maintained for each Executive, aggregating all account balance Plans, non-account balance Plans, and all Plans that are neither account balance nor non-account balance Plans (e.g. equity-based plans). All Q&A references in these footnotes refer to Notice 2005-1.
3. Section 409A does not only apply to employees; it broadly applies to service providers, including individuals (e.g., corporate directors), personal service corporations, qualified personal service corporations and non-corporate entities that would qualify as personal service corporations or qualified personal service corporations if they were corporations. Q&A-8. On the other hand, Section 409A does not apply to arrangements between accrual basis taxpayers or to payments to a service provider (other than an employee or director) who is actively engaged in the business of providing substantial services to two or more unrelated parties (e.g., an employer's payments to its outside auditor).
4. Q&A-21, which also limits deferral choices to those in a written Plan on December 31, 2004. Any deferral elections in 2005 must be prospective, i.e., applicable to amounts that have not been paid or become payable before the date of the election.
5. Q&A-20, which suggests that termination must be all-or-nothing as to the entire Plan. Employers may offer termination elections to Executives on a selective basis.
6. Q&A 20.
7. Q&A-4(a).
8. Q&A-4(c). The preamble to Notice 2005-1 notes that this definition may be prospectively narrowed because the Treasury Department and IRS are "concerned about arrangements purported to involve a substantial risk of forfeiture and fixed payment date where the parties do not intend for the substantial risk of forfeiture or fixed payment date to before enforced."
9. Q&A-10(a).
10. Q&A-4(d)(iv).
11. Id.
12. Q&A-4(d)(ii), citing the estate tax regulations as an example of a reasonable valuation method.
13. Q&A-4(d)(i)(last sentence) and Q&A-19(c).
14. Q&A-18(d), sanctioning adjustments that follow the formula in Treas. Reg. 1.424-1(a)(5).
15. Q&A-4e).
16. Q&A-17.
17. Q&A-17(d).
18. Q&A-22.
19. Q&A-15.
20. Q&A-7.
21. Q&A-19(d).
22. Q&A-23.
23. Q&A-18.
24. Q&As 24 to 30.
25. Q&As 31 to 33.