

New Rules Governing Deferred Compensation

On December 20, 2004, the Internal Revenue Service (IRS) issued the first round of guidance pertaining to the new Internal Revenue Code (IRC) §409A, which was added to the IRC last October as part of the American Jobs Creation Act (Jobs Act). As we reported last fall following enactment of the Jobs Act, IRC §409A imposes significant new restrictions on the design and operation of nonqualified deferred compensation plans and arrangements. The initial guidance is expected to be merely the first of a number of installments intended to clarify the new rules, which took effect January 1, 2005. Issued in the form of questions and answers, Notice 2005-1 addresses a number of areas of immediate concern to employers and offers generous transition rules for bringing all plans into compliance during 2005. Nevertheless, many issues remain and await clarification in subsequent guidance. The key provisions of Notice 2005-1 are summarized below:

Definition of Deferred Compensation

An arrangement results in the deferral of compensation under 409A if a service provider (i.e., the covered employee, director, or contractor) has a legally binding right to compensation in one taxable year, and the arrangement provides for the deferred payment of that taxable income in a future taxable year. This means compensation that is taxed at substantially the same time that it vests generally is not subject to 409A.

Arrangements Covered Under 409A

Notice 2005-1 confirms that a broad range of plans and arrangements are covered under the new law. Following up on the general premise that any plan, agreement or arrangement that provides for deferral of compensation (including individual employment agreements and arrangements with independent contractors and directors) is covered under 409A unless specifically exempted, the guidance elaborates on the status of a number of specific arrangements:

Action Items for 2005

- ▶ Review all plans and arrangements that may be subject to 409A to:
 - ❖ Identify the plans, arrangements and amounts that are subject to 409A;
 - ❖ Determine which amounts, if any, are grandfathered under the old rules;
 - ❖ Identify the plans and provisions that may be operated under transition rules;
 - ❖ Determine what amendments will be required to bring the plans into compliance by the end of 2005.
- ▶ Develop a plan of action to amend, freeze or terminate plans as necessary or desirable before the end of 2005. In developing a time line, take into account the pending issuance of additional guidance in 2005.
- ▶ Put procedures in place to ensure operational compliance in 2005. For example, all distributions of post-2004 deferrals and non-grandfathered pre-2005 amounts must be made only upon distribution events permitted under 409A.
- ▶ For all amounts subject to 409A, administer 2005 deferral and distribution elections (including revocation elections) in compliance with the 409A transition rules.
- ▶ Develop a plan of action to inform participants of the options available to them, including, if desired, the option to terminate participation in a plan.
- ▶ For publicly held companies, evaluate what additional compliance steps associated with the adoption of new plans or the amendment of existing plans are required under securities laws.

Stock Options and Restricted Stock.

- ▶ Nonqualified stock options with an exercise price that equals or exceeds the fair market value of the stock at date of grant are not subject to 409A, so long as the option does not permit subsequent deferral of income. If the option is part of a tandem arrangement with an SAR that permits cash settlement, however, the option will not be exempt.
- ▶ Incentive stock options and Code §423 employee stock purchase plan options are exempt from coverage under 409A. However, an employee stock purchase plan that does not meet the requirements of Code §423 will be subject to the 409A rules.
- ▶ Restricted stock is not subject to 409A so long as the value of the stock is included in income when the stock vests and the participant may not defer payout of the stock to a future taxable year.

Stock Appreciation Rights (SARs). SARs generally are subject to 409A. However, SARs of publicly traded companies are exempt from coverage under 409A if the SARs meet the following requirements:

- ▶ The exercise price may never be less than the fair market value of the stock on the date of grant;
- ▶ The stock is traded on an established securities market;
- ▶ On exercise, the SAR may be settled in stock only; and
- ▶ The SAR has no deferral feature other than the deferral of income related to the exercise right.

SARs that fail to meet these conditions may comply with 409A by providing for a fixed payment date. Pending further guidance, SARs granted under a program in effect on or before October 3, 2004 that have an exercise price equal to the fair market value of the underlying stock on the grant date are exempt from 409A if the SARs do not have a deferral feature.

Bonuses and Other Short-Term Deferrals. Bonuses and other compensation will not be covered under 409A if they are paid within 2½ months after the end of the taxable year (either the employer's or the participant's, whichever is later) in which the amounts are no longer subject to a substantial risk of forfeiture.

Service Providers. Section 409A does not apply to arrangements between a service provider and a service recipient, if (1) the service provider is actively engaged in the trade or business of providing substantial services (other than as an employee or director of a corporation), and (2) the service provider provides the services to two or more unrelated service recipients. Also excluded from coverage are arrangements between taxpayers if all use the accrual method of accounting.

Severance Plans. Severance plans are covered under 409A. However, a severance plan that is either collectively-bargained or covers no key employees is not required to comply with 409A during 2005.

Partnership Interests. Arrangements between a partner and a partnership may be covered by 409A. However, pending further guidance, the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services will not be treated as deferred compensation subject to 409A.

Substantial Risk of Forfeiture Under 409A

Compensation is subject to a substantial risk of forfeiture for purposes of 409A if entitlement to the compensation is conditioned on the performance of substantial future services by an individual or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. Notice 2005-1 further restricts the definition for purposes of 409A, adding the following limitations:

- ▶ A rolling risk of forfeiture is not a substantial risk of forfeiture.
- ▶ Noncompete agreements do not result in a substantial risk of forfeiture.
- ▶ Risk of forfeiture provisions will be disregarded with respect to a service provider with a controlling ownership interest (which, in a widely held corporation, could be a small percentage).
- ▶ A risk of forfeiture may be disregarded if it is added after the service period has begun.

Permissible Acceleration of Payments

In general, a plan may not permit the acceleration of the time or schedule of any payment under the plan. However, Notice 2005-1 provides for the following exceptions:

- ▶ Payment under a domestic relations order.
- ▶ Payment in compliance with a conflict of interest divestiture requirement.
- ▶ Payment to a participant in a §457(f) plan to pay income taxes due on vesting.
- ▶ Plan amendment to permit de minimis cashouts of \$10,000 or less, provided the payment accompanies the termination of the participant's entire interest in the plan.

- ▶ Payment to enable a participant to pay employment taxes on compensation deferred under the plan.

Change in Control Events

Under 409A, deferred compensation payments also may be accelerated in connection with a change in control. Notice 2005-1 provides specific guidance on events that qualify as permissible distribution events related to a change in control of a corporation. They include:

- ▶ A change in ownership involving more than 50% of the total fair market value or voting power of the company stock;
- ▶ A change in effective control of the company involving (1) the acquisition of 35% or more of the total voting power of the corporation's stock, or (2) the replacement of a majority of directors during a 12-month period where their appointment or election is not endorsed by a majority of the pre-existing board; or
- ▶ A change in ownership of a more than 40% of the company's assets.

To qualify as a change in control event, the occurrence of the event must be objectively determinable and not involve any discretionary authority. A company may exercise its discretion to terminate a plan and distribute the compensation within 12 months of a qualifying change in control event.

Note that under current guidance these change in control concepts may not be applied to entities not taxed as corporations.

Transition Rules

Effective Date. The new rules under 409A are generally effective January 1, 2005 with respect to all compensation deferred after 2004 and to all earnings on those amounts. Under the grandfather provisions of 409A, the new rules do not apply to amounts deferred before 2005 (or to earnings on pre-2005 deferrals), unless the plan is "materially modified" after October 3, 2004. To qualify as deferred before 2005, the amounts must be earned and vested by December 31, 2004.

Good Faith Compliance and Plan Amendments. Plan sponsors have until December 31, 2005 to amend existing plans to conform to the provisions of 409A. However, all deferred compensation arrangements that come under the rules of 409A must be operated in good faith compliance with the rules beginning January 1, 2005. Amendments to bring plans into compliance with 409A will not be treated as material modifications that would threaten grandfather status of pre-2005 deferrals.

2005 Deferral Elections. Participants may make elections under existing plans to defer 2005 compensation as late as March 15, 2005, so long as the elections apply only to amounts paid or payable after the date of the election. The elections must be made under a plan or arrangement with a written plan document in place on December 31, 2004.

2005 Payment Elections. Participants in existing plans have until December 31, 2005 to make payment elections with respect to their 2005 deferrals. With respect to amounts subject to 409A, amendments modifying payment elections for amounts already deferred are also permitted, provided the plan is amended and the participant makes the election on or before December 31, 2005.

Cancellation of 2005 Elections. A plan may be amended in 2005 to permit a participant at any time during the year to cancel a deferral election, provided any 2005 deferrals made prior to the cancellation are taxed to the participant in 2005 or, if later, the year the amount is earned and vested. The opportunity to cancel a deferral election need not be granted to all plan participants.

Cancellation of Individual Participation. A plan also may be amended to permit a participant to terminate participation in the plan and receive a distribution, provided the amounts are taxed to the participant in 2005 or, if later, the year the amounts are earned and vested. As with the cancellation of 2005 elections, the opportunity to terminate participation in a plan need not be granted to all plan participants. Permitting participants to terminate participation with respect to nongrandfathered amounts should have no adverse consequences. However, amending a plan to permit participants to elect to terminate participation with respect to grandfathered amounts will be considered a material modification that will subject all amounts in the plan to coverage under 409A, regardless of whether an individual participant elects to terminate participation.

Plan Suspension or Termination. Amending a plan to stop future deferrals is not a material modification of the plan. An existing plan also may be amended on or before December 31, 2005 to terminate the plan and distribute the amounts deferred, as long as all amounts deferred are included in taxable income in 2005. The amendment will not be considered a material modification and grandfathered amounts will not lose grandfather status.

Equity-Based Compensation.

- ▶ Pending further guidance, SARs settled in stock or cash granted under programs in effect on or before October 3, 2004 will be exempt from coverage under 409A, so long as the award does not otherwise have a deferral feature. SARs subject to 409A may be amended to provide for fixed payment terms consistent with 409A, provided the option or

right is amended and the elections are made on or before December 31, 2005.

- ▶ Discounted options also may be cancelled or amended by December 31, 2005 to conform to or be exempt from 409A. For example, options may be amended to eliminate the discount or to make them exercisable only as permitted under 409A. A plan also may be amended to have all vested options exercised by December 31, 2005. Vesting may be accelerated for this purpose.

Performance-Based Bonuses. An election to defer performance-based compensation based on services performed over a period of at least 12 months may be made no later than 6 months before the end of the period. Until additional guidance is issued, a bonus will be treated as performance-based compensation if the payment is contingent on the satisfaction of organizational or individual performance criteria and the performance criteria are not substantially certain to be met at the time of the deferral election. Under certain conditions, the performance criteria may be subjective.

Payments Tied to Qualified Plan Elections. Nonqualified plans with payment elections that are controlled by a participant's elections under a qualified plan may continue to operate under the same provisions throughout 2005, so long as the elections are consistent with the terms of the nonqualified plan as of October 3, 2004.

Adoption of New Arrangement or Grant of Additional Benefit. The adoption of a new plan or the grant of an

additional benefit under an existing plan after October 3, 2004 is presumed to be a material modification of a plan. This presumption may be rebutted if the employer can establish that the adoption of the new plan or the grant of the additional benefit is consistent with its historical compensation practices. Also, the deferral of additional compensation not previously provided under a plan as of October 3, 2004 will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferrals and provides that they are subject to 409A.

New Reporting Obligations

Effective for all amounts deferred after 2004, employers are required to report deferrals of nonqualified deferred compensation on a Form 1099-MISC (Box 15a) or W-2 (Box 12, Code Y) even if the compensation is not yet taxable. Pending further guidance, the reporting requirement does not apply if the total amount of nonqualified deferred compensation deferred by an employee during the year does not exceed \$600.

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