Deferred Decisions on Deferred Compensation: Complications and Practical Steps in Light of the American Jobs Creation Act

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The American Jobs Creation Act of 2004 became law on October 22, 2004 and now imposes significant new restrictions on deferred compensation. If these restrictions are not satisfied, deferred compensation amounts will become taxable as they vest and become subject to tax penalties.

Holland & Hart's Benefits Law Group will release a series of Alerts to assist employers in bringing their deferred compensation arrangements into compliance with the Act. This Alert highlights the Act's key changes to deferred compensation requirements and offers a practical guide for employers until further clarification is provided by the Treasury Department, which is promised within 60 days of the new law's enactment.

Plans Affected. All forms of plans, agreements and arrangements (with certain specific exceptions) that cause compensation to be deferred to another tax year implicate the Act's rules incorporated into a new Section 409A of the Internal Revenue Code. Employers will need to identify and review all elective and non-elective arrangements, including excess or "restoration" plans, supplemental executive retirement plans (SERPs), discounted stock options, stock appreciation rights (SARs), restricted stock units (RSUs), phantom stock plans, severance or employment arrangements with deferral features, and short-term and long-term incentive plans with deferral features. Trusts established for these forms of deferred compensation should also be identified. Excluded from Section 409A rules are certain types of pension and welfare plans, such as tax-qualified retirement, tax-deferred annuity, SEP, SIMPLE and Code Section 457(b) plans; full-price stock option plans and employee stock purchase plans; and bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans.

Tax Consequences. In general, deferred compensation will be subject to taxation as it vests, unless the restrictions of Section 409A are met. If Section 409A requirements are violated with respect to the design or administration of a deferred compensation arrangement, the new rules impose severe tax consequences on the individuals to whom the failure relates: first, all vested deferred compensation is included in gross income; second, interest is imposed at the underpayment rate plus 1% beginning in

the taxable year in which the amounts were first deferred or, if later, the first taxable year in which the amounts were no longer subject to a substantial risk of forfeiture; and third, an additional tax in an amount equal to 20% of compensation included in gross income also applies.

What Are Employers' Choices?
How Will Plans Change?
What Should Employers Do Now?

WHAT ARE EMPLOYERS' CHOICES?

The Act applies to compensation deferred on or after January 1, 2005. Compensation is considered deferred before January 1, 2005 only if the amount is earned and vested before then. The Act also applies to compensation deferred under an arrangement that is materially modified after October 3, 2004. According to the Act's legislative history, if an arrangement is modified to accelerate vesting after October 3, 2004, this change will be considered a material amendment that accelerates the effectiveness of the Act for the modified arrangement.

Given these effective dates, employers must be ready to choose, likely before the end of the year, how to proceed with existing arrangements that involve the deferral of compensation. There are three different approaches available:

1. **Grandfather Existing Deferrals; Amend Arrangements for New Deferrals Only**. Existing plans can continue to apply the old rules to grandfathered amounts and be amended to apply the new rules only to prospective deferrals under the same benefit structure. In the conference report, Congress made it clear that one plan can provide rules for both pre- and post-effective date deferrals.

    a. If two sets of rules are applied, careful administration will be required in tracking the rules that apply to two accounts for each participant: one for pre?2005 deferrals (and earnings thereon), and one for post?2004 deferrals (and earnings thereon).

    b. A single set of rules for all deferrals (new and old) would be easier to communicate and administer, but an employer may not be able to amend the plan unilaterally. Deferred compensation plans often provide that if an amendment would adversely affect the rights of participants, then participant consent must be obtained. Because the rules under new Section 409A may be more restrictive than current arrangements, participants can claim that imposing the new rules on pre-effective date deferrals adversely affects their rights. Also, because a deferred compensation plan

represents a contractual obligation of the employer, IRS guidance does not necessarily preempt a participant's contract rights under state law.

c. Transition rules to be provided by the IRS are expected to provide a reasonable period to permit amendments to existing arrangements (i) to conform the terms of the plan to the new requirements, and (ii) to provide participants with the opportunity to terminate participation in the plan or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, if those amounts are going to be includible in the participant's income as earned.

2. **Freeze Old Plans; Create New Plans**. Employers may want to preserve the plan designs or features applicable to amounts deferred before 2005 and choose to apply the new rules of Section 409A, which may be more restrictive than current arrangements, to new deferrals only.

a. A clean break between prior and new deferrals may assist employers in educating participants on the differences between the old rules and the new rules.

b. It will likely be safer to create a new plan for post-2004 deferrals in order to avoid inadvertent "material modifications" for pre-2005 deferrals.

3. **Apply New Rules to All Deferrals**. Ease of administration and communication make this alternative attractive. Also, depending on the aggressiveness of prior plan designs, applying the new rules to all deferrals may make payment options more liberal for participants.

HOW WILL PLANS CHANGE?

Every type of arrangement affected by the legislation may require extensive revision of detailed provisions. While the IRS has yet to provide guidance that will clarify the extent of these changes, Section 409A makes clear that the provisions that must be changed, or at least reviewed for compliance, include the following:

1. **Prohibition of Acceleration Provisions**. The Act prohibits acceleration of the time or schedule of any payment under the plan (such as from an annuity to a lump sum), except as specifically provided by the IRS guidance. "Haircut provisions" will be prohibited, no longer allowing participants to access their deferred compensation accounts by incurring a penalty (typically 10% of the amount withdrawn). IRS guidance may provide limited exceptions for accelerated distribution. We are hoping to see exceptions for court-approved settlements

incident to a divorce, tax withholdings and automatic distributions of account balances of less than $10,000 upon separation from service of a non-key employee.

2. **Funding Subject to a Substantial Risk of Forfeiture**. The Act would not affect most traditional U.S.-based rabbi trusts, but would regulate the funding of deferred compensation with respect to off-shore trusts and financial distress triggers.

a. Off-Shore Trusts. Assets set aside (directly or indirectly) in an offshore trust for the purpose of paying nonqualified deferred compensation will be treated as property transferred under Code Section 83. These assets will generally be taxable to the extent vested at the time the assets are set aside or transferred outside the U.S., whether or not assets are available to satisfy claims of creditors.

b. "Springing" Trusts Upon Financial Distress. A transfer of property also occurs under Code Section 83 if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of benefits (for example, by deposit into a trust), or will occur on the date on which assets are so restricted.

3. **Distributions as Specified and Defined**. Distributions will need to be limited to particular events, many as narrowly defined in Section 409A.

a. Deferred compensation distributions are permitted only upon—

i. the participant's separation from service with the employer and closely-related affiliates, or 6 months after separation from service for "key employees" of publicly-traded companies;

ii. "disability" of the participant;

iii. death of the participant;

iv. a specified time, or pursuant to a fixed schedule, which must be elected at the initial date of deferral (and not upon the occurrence of an event, such as when the participant elects to receive a distribution from a qualified pension or 401(k) plan);

v. a "change in control" of the employer; or

vi. an "unforeseeable emergency" of the participant.

b. **"Key employees"** of publicly-traded companies will include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), 5% owners, and 1% owners having annual compensation from the employer greater than $150,000.

c. **"Disability"** means that the participant (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

d. Distributions will be permitted upon a **"change in control"** to the extent provided in IRS guidance, and will depend on the IRS definition of that term. IRS guidance is expected to address a change in ownership or effective control of the employer and a change in the ownership of a substantial portion of the assets of the employer.

e. **"Unforeseeable emergency"** means a severe financial hardship to the participant (1) resulting from an illness or accident of the participant, the participant's spouse or a dependent; (2) loss of the participant's property due to casualty; or (3) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution.

4. **Distribution Elections Required, with Restrictions on Changes**. Initial deferral elections will be required to specify

the form of distribution (and if permitted by the arrangement, the time of distribution) ultimately paid to a participant. The participant will be not be able to accelerate the time or schedule of any distribution, but may change that election to delay the distribution or to change the form of payment if the election meets the following conditions:

a. The election must be made at least 12 months before it is to be become effective.

b. The new payment date must be at least 5 years after the original payment date with respect to distributions other than on account of death, disability or unforeseeable emergency.

c. The election must be made at least 12 months prior to the date of the first scheduled payment, if related to payment at a specified time or pursuant to a fixed schedule. Thus, once a participant is in pay status, no additional deferral is permitted.

5. **Distinguish Between Performance-Based and Other Compensation**. The deferral of "performance-based compensation" is likely to provide more planning opportunities for employers and participants than the deferral of other forms of compensation. The IRS is expected to define "performance-based compensation" to include compensation to the extent it is (a) variable and contingent on the satisfaction of preestablished organizational or individual performance criteria, and (b) not readily ascertainable at the time of the election. "Performance-based compensation" will likely be required to meet certain requirements similar to those under Code Section 162(m) (providing for the exclusion of certain compensation from public company deduction limits). To take advantage of maximum planning opportunities, employers should consider how it may define and put in writing performance criteria at least 3 months prior to the service period to be measured.

WHAT SHOULD EMPLOYERS DO NOW?

Even with many unanswered questions about the new law, there are steps employers can and should take now – before further guidance is released – to prepare for the legislation. They are as follows:

1. **Inventory** all plans that are or may be subject to the legislation.

2. **Notify executives**, employees and contractors – all participants – who may be impacted by the new rules. Summarize how the election and distribution provisions of the elective deferral plan may be changed beginning just prior to the 2005 plan year.

3. **Locate your decision-makers and participants** who may be impacted by the new rules, as well as your governing board or compensation committee members who must approve changes. Obtain their travel plans and contact information for the final two weeks of 2004. Because the IRS has until December 21 to release guidance that is essential to employers' decision-making, amendments and new agreements may need to be delivered by overnight courier to your executives around the globe. Prepare your overnight envelopes early to simplify that last-minute rush.

4. **Choose among the 3 design options**, as described above.

a. The new Section 409A leaves many questions unanswered, and so, the Treasury regulations are likely to be extensive. The conference report provides that employers will be given a reasonable period of time after Treasury guidance is issued; given the current timing constraints, employers will have about 10 days unless Treasury provides for more time.

b. Even if employers delay in making a comprehensive amendment to their plans to incorporate all aspects of Section 409A, employers should consider adopting a short plan amendment before January 1, 2005 to provide that post-2004 deferrals will be subject to the requirements of new Section 409A. Treasury may provide additional guidance on this point.

5. **Do not make any changes** to any plans without considering whether the change is a "material modification" that could cause the loss of grandfathering treatment for pre-2005 deferrals. Note that the addition of any benefit, right or feature will be considered a material modification, but that the exercise or reduction of an existing benefit, right or feature is not a material modification.

6. **Modify participant communications, enrollment and administrative forms**. Employers should review and, to the extent necessary, update tax discussions and other participant communications regarding deferred compensation. In addition, companies will likely need to update their enrollment materials and administrative forms in response to the Act.

7. **Evaluate corporate governance procedures** for adopting amendments or new plans. Employers should evaluate their procedures for amending existing plans and adopting new plans, as well as the timing needed to complete these actions.

a. Governing boards and compensation

committees will need adequate briefing of these issues at an upcoming meeting.

b. NYSE and Nasdaq rules may require shareholder approval of some plan amendments for public companies. Also, public companies should evaluate compliance with public reporting and disclosure obligations. Adopting or modifying a deferred compensation plan may trigger reporting or disclosure obligations in periodic reports (Forms 8-K, 10-Q and 10-K) and/or proxy materials.

8. **Plan for the elective deferral of 2004 bonuses and 2005 compensation to be paid in 2005**. Employers should prepare to have participants make elections to defer salary and bonus for services performed in 2005 prior to December 31, 2004, unless the bonus meets the exception for performance-based compensation.

a. If the bonus is earned and vested before January 1, 2005, and the existing arrangement permits deferral elections in 2004, then participants should be able to make current deferral elections for bonuses to be paid in 2005 subject to current law (before enactment of Section 409A). Consider including the specific distribution timing and form in these deferral elections, as certain distribution dates or form not elected in a participant's initial deferral election may not be correctible by making a later election.

b. If the bonus is not earned or not vested before January 1, 2005, then the 2005 bonus would be subject to the requirements of Section 409A, so an election late in 2004 for a 2005 bonus payout would not satisfy the timing rules of Section 409A. Nonetheless, the IRS might provide transition relief for 2005 bonuses, so there may be little to lose in permitting late 2004 elections for unvested bonuses to be paid in 2005.

9. **Plan for the elective deferral of "performance-based" 2005 compensation**, for which the service period begins in 2005. Determine whether the compensation is likely to meet the definition of "performance-based compensation" that would permit deferral elections to be made as late as 6 months before the service period ends (June 30 for annual bonuses, 6 months before end of a multi-year incentive period). Also consider requesting participants to make deferral elections in 2004 for bonuses to be earned in 2005 and paid in 2006.

10. **Continue accepting elective deferrals** of base pay or other non-performance-based 2005 compensation for which the service period begins in 2005 after evaluating the plan for compliance with Section 409A. Transitional relief is expected to provide participants with the opportunity to terminate participation in the plan or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004 if those amounts are going to be includible in the participant's income as earned.

11. **Consider design options** for the payment of restricted stock units (RSUs), stock appreciation rights (SARs) and phantom stock.

a. RSUs often provide that payment will occur at a fixed time. These types of arrangements will comply with the restrictions of Section 409A.

b. SARs and phantom stock rarely provide for exercise as of a fixed date.

i. SARs and phantom stock that vest prior to January 1, 2005 are likely to be treated as grandfathered under the pre-Act rules, avoiding restriction under Section 409A.

ii. With respect to SARs and phantom stock that do not vest by December 31, 2004—

(1) refrain from accelerating vesting during 2004. The acceleration of vesting is likely a "material modification" that will result in immediate taxation; and

(2) consider whether these deferrals fit within the definition of performance-based compensation, thus permitting flexible exercise with 6 months advance notice by the participant.

iii. With respect to SARs and phantom stock to be granted in 2005 or later, consider designing the

arrangement to fit within Section 409A. For example, a plan might require that participants elect the date of exercise at the time the SAR or phantom stock is granted, or provide for a fixed exercise date, or incorporate sufficient performance-based criteria to make the SARs or phantom stock performance-based.

12. **Wait for IRS guidance** before communicating changes to supplemental executive retirement plans (SERPs) and any non-elective plans that permit the participant to choose (after the commencement of the service period to which the deferred compensation relates) between different forms of annuity, installment and lump sum distribution.

If you have questions or would like assistance with bringing your deferred compensation arrangements into compliance, please contact a member of the Benefits Law Group of Holland & Hart LLP.

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