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Deferred Compensation Legislation Casts a Wide Net—All Employers Need to Review Their Severance, Employment, and Compensation Arrangements

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The American Jobs Creation Act of 2004 (the Act), enacted in October 2004, radically changes the rules governing permissible deferral elections and distributions for most deferred compensation arrangements that are not "qualified" pension, 401(k), or 403(b) plans. Very generally, the Act (a) requires that any election to defer compensation or postpone receipt further be made in advance and set a date of payment in accordance with specified terms under a written plan, (b) limits flexibility to accelerate or change the date chosen to receive deferred compensation and, (c) in some cases, delays receipt of compensation for six months after a key employee terminates employment. The rules are contained in a new section of the Internal Revenue Code—Section 409A—governing nonqualified deferred compensation arrangements. The Act is generally effective January 1, 2005, but because its enactment is so recent and its scope so far-ranging, both Congress and Treasury anticipated that 2005 would be a type of "transition year," at least for many of the more common arrangements used by employers, although some rules are effective immediately.

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Employers need to recognize that most arrangements providing deferred compensation are covered by the new law. These include severance plans and agreements, employment agreements, certain insurance arrangements, and plans that "wrap" around qualified 401(k) and 403(b) arrangements to provide benefits in excess of qualified plan limits. Thus, employers negotiating or administering these arrangements need to know what the law provides and the timetable for coming into compliance. They must also make sure that they do not inadvertently modify arrangements that are "grandfathered," or create another deferred compensation arrangement subject to these rules. This becomes important, for example, when employers provide a fired employee with severance payments.

Background and Effective Date

The Act was considered by many as a response to certain practices at Enron and other scandal-plagued corporations that allowed their executives to receive deferred compensation payments just before the companies declared bankruptcy or engaged in other actions that jeopardized rank and file employees' jobs and pensions. But the Act addresses more than these practices, and affects a variety of compensation arrangements that have been widely in use for a long period of time and in some cases ratified by the courts in cases that the IRS lost. Treasury officials and Congressional staff maintain that Congress deliberately intended that the legislation give the IRS broad authority to limit employees' flexibility to defer compensation.

The Act applies to amounts deferred in taxable years beginning after December 31, 2004. Only amounts that are "vested" in 2004 will be considered deferred before 2005. Thus, compensation that was deferred in a prior year but not vested until after 2004 is subject to the new rules. Amounts deferred for preceding taxable years may also be subject to the rules if a grandfathered deferred compensation plan is materially modified after October 3, 2004.

Congress recognized that the Act would result in major changes to deferred compensation arrangements, and thus required that the Treasury Department issue guidance within 60 days of the Act's enactment (i.e., on or before December 21, 2004). Treasury met that requirement with one day to spare with the issuance of Notice 2005-1, (the "Notice") on December 20, 2004. Notice 2005-1 takes the form of questions and answers and does not provide answers to all questions employers have. Nonetheless, the Notice provides some basic parameters for employers and gives some transition rules that will help employers accommodate their compensation policies to the Act. Further guidance is expected in the middle of 2005.

Arrangements Not Subject to the New Rules

Although the Act applies broadly to any plan, program, or individual agreement that provides for the deferral of compensation (and includes earnings in such compensation), there are the following limited exceptions under the statute:

- Qualified employer plans, including 401(a) plans, 403(b) plans, SEPs, SIMPLEs, qualified governmental excess benefit arrangements under 415(m) and 457(b) plans;

- Certain nonqualified deferred compensation plans under 457(e)(12); and

- Bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.

Notice 2005-1 also takes an initial step at defining the deferred compensation subject to the new rules in conjunction with the Act's legislative history. Deferred compensation is generally defined as amounts to which the service provider has a legally binding right but whose payment is deferred to a later year. The deferral does not have to be elective in order to be covered by the rules. For purposes of this definition, the Notice says that a person providing services does not have a legally binding right to compensation if the compensation can be unilaterally reduced by the service provider or service recipient. However, the Notice also states that if the discretion to reduce or eliminate the compensation is unlikely to occur, the servicer provider will be deemed to have the binding right to compensation and delayed payouts from that point on will be subject to the new rules (absent exceptions).

The Notice excludes certain specific categories of payments as exempt from the rules, including medical reimbursement arrangements, health savings accounts and health reimbursement accounts, and business payments between accrual basis taxpayers.

Notice 2005-1 expands on the Act's legislative history with a temporary rule (at least unless and until repealed by later guidance) providing that if an employer defers vesting but pays the employee a lump sum right after vesting—or within 2 1/2 months at the end of the year of vesting—that arrangement is not subject to the rules.[1] Note too that the 2 1/2 month rule is technically measured from the end of the later of the employer's tax year or the service provider's tax year. Thus, amounts in which an executive vests in 2005 (even if in January 2005) and are paid by March 15, 2006, will not be considered "deferred compensation" under this temporary rule.

The treatment of options and stock appreciation rights was a source of contention, particularly because deferring a fixed date of payment would change the essential nature of these arrangements. The legislative history made it clear that the stock options granted at fair market value should be excluded, and the Notice confirms this. The rule for stock appreciation rights is tougher, however. The Notice only excludes from the new rules stock appreciation rights for publicly traded companies granted at fair market value and related to stock traded on an established securities market that are satisfied in stock and that do not contain any deferral features other than the exercise right. Stock appreciation rights for publicly traded companies (including rights that provide for settlement in cash) under programs in existence on or before October 3, 2004 will not be subject to the new rules until further guidance, if the rights also are issued at fair market value, are not modified, and do not provide for additional deferral.[2] Until a week before the Notice was issued, Treasury officials had informally taken a hard line on stock appreciation rights, arguing that Congress had intended them to be covered by the Act. Treasury changed its mind after receipt of letters from Congress indicating Congress' belief that the legislative history gave Treasury more flexibility in this area.

Restricted stock is not considered deferred compensation. Special rules, however, would apply to promises to transfer shares in the future.[3]

Grandfathered Arrangements

The Act does not apply to vested amounts deferred before 2005 ("grandfathered amounts") if such amounts were deferred pursuant to a plan or arrangement in place on October 3, 2004 (the date of enactment). This grandfather also applies to earnings attributable to such deferrals. The Notice makes it clear that no formal procedures to amend the plan or establish a frozen grandfathered plan are required. Thus, a grandfathered amount can remain in the same plan, although employers will have to find a way to trace amounts subject to the grandfather and any earnings attributable thereto.

If an employer plans to rely on grandfather rules it should make sure it does nothing to create a "material modification" to the arrangement covering the grandfathered deferrals. A material modification is occurs whenever a benefit is enhanced or a new benefit or right is added after October 3, 2004.[4] Thus, allowing additional deferral elections or providing new distribution options, even if consistent with Section 409A, would be a material modification. On the other hand, restricting a distribution option (*e.g.,* allowing a deferral election to be made only once a year rather than every month) would apparently not be a material modification.

It is important to note that even though the guidance allows certain mid-2005 elections in order to comply with Code Section 409A, including the ability to elect to negate a deferral election and receive compensation in 2005, applying those elections to amounts that are grandfathered would be a material modification. Thus, although participants who elected to take the amounts into income in 2005 would suffer no adverse consequences under the transition rules discussed below, (other than the income inclusion that was a consequence of their election), participants who are offered an election to take the deferred compensation in 2005 and decline will find that their old deferral amounts are now subject to the requirements of Section 409A.

Arrangements That Are Covered by the Rules

As noted above, the Act's scope is very broad, and individuals who do not normally focus on tax issues—for example, those who negotiate severance arrangements and employment agreements—need to be aware of how it operates.

The Act affects common practices under "wrap around" or so-called "make-up" plans that give participants the opportunity to defer amounts in excess of the dollar limits permitted to be deferred under 401(k), 403(b) and qualified plans. Although these arrangements may be administered like qualified plans, they are nonetheless subject to the new deduction/timing rules. For example, many of these plans cover a large group of employees and mirror qualified plans by permitting benefit distribution options to be elected at or close to the time of retirement (or by requiring that the payout option to be the same as the qualified plan). Such elections are not permitted (or severely restricted) under the new rules.

Treasury officials have also taken the position informally that elections under qualified 401(k) plans affecting the amounts of "excess plan" deferrals may have to be restricted (if that 401(k) election causes the relative amounts in the 401(k) and nonqualified plan to shift or changes the amounts deferred in the nonqualified plan) to avoid allowing indirect changes to the amounts of nonqualified deferrals subject to Section 409A. This concept has raised a great deal of concern among employers, because the Notice does not clearly articulate this problem (or how to address it), and 401(k) plans generally are often administered by third parties who have difficulty adapting their electronic election procedures quickly to comply with the law. At least until 2006, however, the election of the form of benefit under a 401(k) plan (even if it affects the *form* of benefit under the nonqualified plan) does not have to follow the rules of Section 409A. However, the treatment of elections of *amounts* of benefits under section 401(k) plans that indirectly affect an employee's nonqualified deferred compensation is not as clear.[5]

Finally, it is important to note that the Act does not only cover agreements between employers and employees. The statute covers deferred compensation agreements with third parties. Therefore, arrangements for deferred payments to directors, consultants and other independent contractors could be subject to the new rules. But Notice 2005-1 carves out from Section 409A arrangements with service providers (1) who are engaged in the business of providing services, (2) who are not providing services as employees or directors, and (3) who work for two or more unrelated service recipients.[6] Agreements among partners in partnerships and between employees and personal service corporations are subject to the rules. However, the Notice provides a limited exception, at least temporarily, for the issuance of partnership interest between a partner and a partnership.[7]

Application of the Rules to Severance Arrangements and Employment Agreements

Severance arrangements may cause numerous questions for employers. Many employers establish an ad hoc severance arrangement when an individual is terminated. If such an arrangement is in fact established and payout as a lump sum occurs immediately thereafter, those arrangements are likely not subject to Section 409A under the 2 1/2 months/short-term deferral exception. But many arrangements do not operate that way. For example, some severance payments provide for installment payments, or even for an election by an employee as to the type of payment. These may need to be changed.

Similarly, a number of employment agreements provide for severance pay if an individual resigns under certain circumstances. Treasury is concerned that this might establish in some cases a right to severance pay at the election of the employee, so that the right would be deemed "vested" when the employment agreement is signed (rather than at any later severance) and could therefore create "deferred compensation" under Section 409A. Thus, the guidance does not specifically address this situation and it is not clear when and how Treasury will deal with it in the future.

Specific Limits Imposed by the Act

The Act limits the timing of both the initial and subsequent deferrals of compensation, and limits changing of these elections through acceleration provisions.

Generally, under the statute, elections to defer compensation earned during a taxable year must be made no later than the close of the preceding year. The time and form of distributions must be specified at the time of initial deferral. "Performance-based compensation" (which is not yet defined) must generally be deferred at least six months before the end of a service period of 12 months or more.

Any changes to deferral elections are subject to strict limitations. Among other requirements, an election must be changed no less than 12 months prior to the date of the first scheduled payment, and subsequent deferrals must be for an additional period of at least five years.

The Act allows plans to require distributions during the following events: separation from service (subject to certain limits for key employees), death, the occurrence of a specified time (as opposed to the occurrence of a specified event), change in control of a corporation (to the extent allowed in regulations), the occurrence of an unforeseeable emergency, or disability of the participant. Note that the definitions of emergency and disability are to be specified in regulations and may be stricter than the definitions employers are currently using. Distributions subject to a "haircut" (*i.e.,* distributions made before the elected date of deferral when requested by the employee/service provider but in a reduced amount to reflect the early receipt) are specifically not permitted.

Subject to certain exceptions, distributions cannot be accelerated under the Act unless the timing of the election change meets the new requirements of Section 409A. This means that upon certain distribution events (for example, termination of employment) participants cannot change the form of distribution (for example, electing a lump sum form of payment rather than installments).

Key employees of publicly traded companies must wait at least six months after they terminate employment to receive deferred compensation subject to the Act. This rule was enacted to prevent such employees from quitting and taking their compensation just before bad news affecting a company's economic viability and stock price becomes public. Interestingly, Treasury officials have informally confirmed that due to the transition relief discussed below (which allows cancellation of deferral elections in 2005), this "six-month delay" rule may not be effective as a practical matter until 2006.

Penalties for Violating the Rules

All amounts deferred under nonqualified deferred compensation plans that fail to meet the requirements of the Act will generally be includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. In addition, interest (cumulative from the failed arrangement's deferral date), will be charged at the Federal penalty rate plus one percent from the date of failure and a 20 percent "additional" tax will be imposed on the amount included in income. Although not discussed in detail here, the Notice indicates that there will be aggregation of similar types of plans covering one individual for purposes of these penalties.[8]

2005 Transition Relief

The Notice does give companies and their employees some additional flexibility with respect to elections for the 2004 and 2005 year, but this flexibility is not complete. Under the Notice, initial deferral elections made by March 15, 2005 were not to be subject to the timing rules governing initial deferrals. This means that employers could have changed elections with respect to the amount of 2005 deferrals before March 15, 2005, even if the election is made in the same year as the year of deferral (*i.e.,* 2005).

The Notice provides that certain deferred compensation elections can be "unwound" if accomplished before the end of 2005. For example, plans adopted before December 31, 2005 may (but need not) be amended to allow a participant to terminate participation in a plan or cancel a deferral election (on a participant by participant basis) with respect to amounts subject to section 409A.[9] For example:

- Under the Notice, an employee can elect to make a second deferral election if the amount has not yet been deferred, as long as such election is made within 2005 and the plan is amended by the end of 2005 to reflect this change. The second deferral election does not have to meet the requirements for second elections; for example, an employee need not require a redeferral of at least 5 years in 2005; it can be deferred for a shorter period.[10]

- Under the law as enacted, technically starting in 2005, no "accelerations" of previously deferred amounts would be permitted. Further, "key employees must wait six months after termination to receive distribution. Nonetheless, Q&A-20 of the Notice also allows individuals to elect to receive their deferred compensation in 2005 rather than to be subject to the new rules.

The Notice allows arrangements to operate in compliance with Section 409A (and the transition rules) without the need for an amendment before the applicable elections are made or restrictions imposed. However, a plan amendment bringing arrangements into compliance (and presumably describing any transition procedures) needs to be in place by December 31, 2005.

Conclusion

New Section 409A is a widesweeping rule that encompasses compensation arrangements of all employers, large and small. The 2005 transition period is helpful, but nonetheless the prompt review of an employer's deferred compensation arrangements is necessary to meet 2005 compliance deadlines. Employers must also take care to remind human resources and other personnel negotiating or revising severance packages that their actions can have significant consequences—such as the loss of a grandfather or an incorrect deferral election. In the long run, it appears that many employers and employees will be sacrificing some flexibility in their deferred compensation arrangements to comply with the new rules.

Notes

1. *See* Notice 2005-1 at Q&A - 4(c).
2. *See* Notice 2005-1 at Q&A-4.
3. *See* Notice 2005-1 Q&A 4(e).
4. *See* Notice 2005-1 at Q&A-18.
5. *See* Notice 2005-1 Q&A-23.
6. *See* Notice 2005-1 at Q&A-8.
7. *See* Notice 2005-1 at Q&A-7.
8. *See* Notice 2005-1 Q&A-9.
9. *See* Notice 2005-1 Q&A-20.
10. *See* Notice 2005-1 Q&A-19(c).

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