K&L ALERT

Compensation & Benefits

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Internal Revenue Service Issues Nonqualified Deferred Compensation Plan Guidance

On December 20, 2004, the Internal Revenue Service issued Notice 2005-1. The Notice contains eagerly anticipated guidance on the new rules applicable to nonqualified deferred compensation plans (NDCPs) enacted in October as part of the American Jobs Creation Act of 2004 (the Act). (For a summary of the NDCP provisions of the Act, you can obtain a copy of our Alert on that subject at: http:www.kl.com/files/tbl_s48News/PDFUpload307/10753/CBA1004b.pdf

This Alert summarizes the most significant aspects of the notice. The Notice addresses a number of issues left unresolved in the Act, including pressing transition issues raised by the January 1, 2005 effective date of the Act. However, many issues remain unresolved and are expected to be addressed in further guidance to be issued in 2005. Fortunately, the Notice contains liberal transition relief for 2005 that will give companies adequate time to assess their deferred compensation arrangements and bring them into full compliance by the end of 2005.

EMPLOYER ACTION ITEMS

- Solicit new 2005 deferral elections by March 15, 2005.
- Solicit new payment form and timing elections for pre-January 1, 2006 deferrals by December 31, 2005.
- Coordinate immediately with outside plan recordkeepers, administrators and other vendors.
- Offer employees an opportunity to terminate plan participation or cancel prior deferral elections by December 31, 2005
- Cancel or reissue previously granted stock options and stock appreciation rights by December 31, 2005 to the extent they would be characterized as deferred compensation under the new rules, and ensure that any replacement grants are structured so that they are not characterized as deferred compensation.
- Amend nonqualified deferred compensation plan documents by December 31, 2005 to comply with the new law.
- For employers that wish to avoid subjecting an existing nonqualified deferred compensation plan to the new rules, freeze or terminate the plan by December 31, 2004. Employers may also avoid the new rules by freezing the plan by December 31, 2004 and terminating the plan by December 31, 2005.

The Act applies to deferred compensation payable to employee and nonemployee service providers (*e.g.*, directors, consultants and independent contractors). For convenience, this Alert refers to service providers as employees and service recipients as employers; however, unless otherwise indicated, the rules apply equally to covered deferred compensation arrangements outside the employment context.

GRANDFATHERING ISSUES

Amounts deferred on or after January 1, 2005 are subject to the Act. Amounts deferred before January 1, 2005 are not subject to the Act (*i.e.*, are grandfathered) unless the NDCP under which the amounts are deferred is materially modified after October 3, 2004. The Notice contains a number of rules designed to clarify whether deferred compensation amounts are grandfathered.

- Date of Deferral. Compensation is considered deferred before January 1, 2005 only if it is earned and vested before January 1, 2005 and the employee has a legally binding right to be paid the compensation. Thus, for example, a discretionary bonus earned by the performance of services in 2004 but paid in 2005 is not grandfathered if the employer can decide after 2004 not to pay the bonus or to reduce the amount of the bonus. As indicated below, if there is no opportunity to further defer payment of the bonus, the arrangement is not an NDCP.
- Grandfathered Amount. In an account balance plan (*i.e.*, a defined contribution plan), the grandfathered amount is the employee's earned and vested account balance as of December 31, 2004.

  In a nonaccount balance plan (*i.e.*, a defined benefit plan), the grandfathered amount is the lump sum actuarial present value (using reasonable actuarial assumptions) of the earned and

vested benefit that the employee could receive if he or she were to terminate service without cause on December 31, 2004 and to receive payment on the earliest date possible under the plan. Any increase in such present value on or after January 1, 2005, such as an early retirement subsidy to which an employee becomes entitled on or after January 1, 2005, would not be grandfathered.

In an equity compensation plan, the grandfathered amount is the payment available to the employee (or that would be available to the employee if the right to the equity compensation were presently exercisable) on December 31, 2004 (excluding any exercise price or other amount that the employee must pay).

Earnings (actual or notional) on otherwise grandfathered amounts are themselves grandfathered, whether the earnings are generated before or after January 1, 2005. Earnings include the increase in the lump sum actuarial present value of an accrued benefit under a defined benefit plan due solely to the passage of time. Earnings under an equity compensation plan include increases in the amount payable under the plan as a result of appreciation in the value of the underlying stock on or after January 1, 2005.

- Material Modification. A plan is considered materially modified after October 3, 2004 if a benefit or right is enhanced or a new benefit or right is added on or after that date. Although amending a plan to comply with the Act is not generally considered a material modification, amending a plan to add or enhance a benefit or right is nonetheless considered a material modification, even if the enhancement or addition complies with the Act (*e.g.*, adding a new distribution trigger for unforeseeable emergency). It is not clear whether amending a plan to take advantage of the transition rules described below in a plan that already complies with the Act may be viewed as a material modification.

  The elimination or reduction of an existing benefit or right is not a material modification (*e.g.*, the removal of a "haircut" forfeiture provision).

  The adoption of a new arrangement or the addition of a benefit under an existing arrangement after October 3, 2004 is presumed to be a material modification. However, the presumption can be rebutted if the employer can demonstrate that the adoption is consistent with the employer's historical compensation practices. Thus, it appears that grants of stock appreciation rights or stock options under an otherwise unmodified plan will be viewed as a material modification of the plan unless the grants are consistent with the employer's historical compensation practices. For example, if an employer grants stock appreciation rights or stock options subject to the Act under an equity compensation plan on November 1, 2004, the employer can rebut the presumption that the grant materially modified the plan by demonstrating that the employer customarily grants stock appreciation rights or stock options annually on November 1 of each calendar year.

  The freezing of a plan at any time is not a material modification of the plan. The termination of a plan on or before December 31, 2005, and the payment of all benefits thereunder in the taxable year in which the termination occurs, is not a material modification.

  The cancellation and reissuance of a stock option or stock appreciation right subject to the Act on or before December 31, 2005 is not a material modification if the replacement stock option or stock appreciation right would not have been subject to the Act had it been granted on the original grant date. The replacement stock option or stock appreciation right must be exercisable for the same number of shares as the original stock option or stock appreciation right and may not include any additional benefit (other than any benefit resulting from the change necessary to keep the stock option or stock appreciation right from being subject to the Act).

TRANSITION ISSUES

The Notice establishes a number of transition rules that will assist employers and employees in adjusting to the new rules under the Act.

- Good Faith Operational Compliance. A plan adopted before December 31, 2005 (including a plan existing on the January 1, 2005 effective date of the Act) will not be treated as violating the Act during 2005 provided that the plan is operated in accordance with a good faith, reasonable interpretation of the Act and the Notice during that period.

- Plan Amendments. Plans adopted before December 31, 2005 (including plans existing on the January 1, 2005 effective date of the Act) must be amended to reflect the provisions of the Act by December 31, 2005. Plans that are not amended by this date will not be able to take advantage of the good faith operational compliance rule described above.

- Termination of Participation or Cancellation of Deferral Elections. An employee may make an election at any time before December 31, 2005 to terminate participation in a deferred compensation plan or cancel a deferral election if the amounts subject to the termination or cancellation are included in the employee's income in the year in which the amounts are earned and vested. An employee can exercise this right in whole or in part. The relief only permits an employee to decrease or eliminate an election, but it does not permit an increase in a prior deferral election. For example, amounts previously deferred by an employee prior to January 1, 2005 that are not grandfathered (and that are, therefore, subject to the Act) may be paid to the employee if the employee elects to terminate his or her participation in the plan by December 31, 2005.

- Deferral Elections. Deferral elections with respect to compensation earned for services performed in 2005 can be made as late as March 15, 2005. Ordinarily, the Act would require any such election to have been made by December 31, 2004. Unlike the transition rule described above, this transition rule would permit an employee to increase the amount deferred under a prior election.

- New Payment Elections. A plan may permit employees to make new elections on or before December 31, 2005 regarding the form and timing of payment with respect to any amounts deferred prior to the date of the new election. Many plans do not currently require employees to make elections regarding the form and timing of payment at the time of initial deferral. Amounts deferred under these plans that are not grandfathered will become subject to the Act's requirement that elections regarding the form and timing of pay-

ment be made at the time of initial deferral. Of course, for previously deferred amounts, it would be too late to file an election regarding the form and timing of payment. This rule gives employees an opportunity to fix that problem through December 31, 2005.

- Tandem Qualified Plan Payment Elections. Many NDCPs provide that elections regarding the form and timing of payment will be the same as those made under a related tax-qualified retirement plan under Section 401(a) of the Internal Revenue Code. Because most tax-qualified retirement plans permit payment elections to be made after the date of initial deferral, such arrangements may violate the rule under the Act that requires all elections regarding the form and timing of payment to be made at the time of initial deferral. The Notice provides that such a tandem qualified plan election made on or before December 31, 2005 will not violate the Act, provided that the NDCP contained the tandem election procedure on October 3, 2004. The Notice states that this relief is only relief from the requirements of the Act, not relief from any tax rule that might otherwise prevent deferral, including, for example, principles of constructive receipt.

- Bonus Compensation. Until the Internal Revenue Service issues additional guidance, contingent bonuses (*i.e.*, bonuses the payment of which or the amount of which are contingent upon the satisfaction of organizational or individual performance criteria that are not substantially certain to be met at the time of deferral) will be treated as performance-based compensation to the extent the bonuses are based upon services performed over a period of at least 12 months. This transition rule will permit deferral elections with respect to bonuses to be made at the same time as other performance-based compensation—*i.e.*, as late as six months before the end of the bonus period. Subjective employee-focused performance criteria are permitted if neither the employee nor a family member of the employee has discretion to determine whether the performance criteria have been satisfied. The Internal Revenue Service anticipates that when it issues guidance on the meaning of performance-based compensation, it will be more restrictive with respect to bonus compensation.

- Certain Severance Plans. The Notice exempts from the requirements of the Act during the 2005 calendar year collectively bargained severance plans and severance plans that benefit no key employees. This relief only applies to severance plans that constitute "welfare benefit plans" under the Employee Retirement Income Security Act of 1974. Severance plans that are structured as pension plans cannot take advantage of this relief. Severance plans are generally considered welfare benefit plans if the severance payments do not exceed two times the employee's annual compensation during the year immediately preceding termination and the payments are completed within 24 months following termination of employment or the employee's normal retirement age.

DEFINITION OF DEFERRED COMPENSATION AND GENERAL RULES OF COVERAGE

The Act defines the term "nonqualified deferred compensation plan" unhelpfully as a plan that provides for the deferral of compensation. It left unanswered whether a number of common compensatory arrangements, such as stock appreciation rights and bonus arrangements that make payment upon vesting, are considered NDCPs. The Notice provided some additional guidance in this area.

- General Rule. A plan provides for a deferral of compensation only if the employee has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income and that, under the terms of the plan, is payable in a later year. In a so-called "negative discretion" plan—*i.e.*, a plan under which the employer retains discretion to reduce the amount of payment or not to make any payment at all—the employee does not have a legally binding right to the payment for the period during which the employer has such discretion. Thus, if payment is made in the year when the employer's discretion lapses, the plan does not defer compensation and is not subject to the Act.

- Payroll Period Deferrals. A plan that defers payment of compensation to the end of the employer's customary payroll period in which the employee obtains a legally binding right to the payment is not considered a deferral of compensation even though the payment may be made in the tax year following the tax year in which it is earned.

- 2-1/2 Month Deferrals. Pending the issuance of further Internal Revenue Service guidance, a plan will not be viewed as deferring compensation if payment is made within 2-1/2 months after the end of the employer's or employee's tax year in which the employee acquires a legally binding right to the payment and the compensation is no longer subject to a substantial risk of forfeiture (*i.e.*, vested). Thus, for example, for a calendar year employer, if a plan provides for bonus payments on March 15th of the year following the end of a three-year performance period, the plan will not be considered an NDCP subject to the Act.

- Substantial Risk of Forfeiture. The Notice states that compensation will be considered subject to a substantial risk of forfeiture (*i.e.*, unvested) if (i) it is conditioned upon the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation (*i.e.*, the employee's performance or the employer's business activities or organization goals) and (ii) the possibility of forfeiture is substantial. If compensation is paid immediately upon vesting in a year following the year in which it is earned and the vesting condition is not a "substantial risk of forfeiture" within the meaning of the Act, the arrangement will be considered an NDCP.

  Any extension of the vesting period or any vesting criteria added after the beginning of the service period to which the compensation relates will not be taken into account for this purpose. Thus, the "rolling vesting" feature under some Section 457(f) deferred compensation plans of tax-exempt organizations and state and local governments that is designed to postpone vesting (and, therefore, taxation under Section 457(f)) does not work under the Act.

- Stock Appreciation Rights. A controversial question left unresolved by the Act was whether stock appreciation rights would be considered deferred compensation. The Notice generally provides that they are with two significant exceptions.

  First, until the Internal Revenue Service issues additional guidance, a stock appreciation right granted on or before October 3, 2004 will not be treated as deferred compensation if the exercise price of the stock appreciation right is never less than the fair market value of the underlying stock on the date the stock appreciation right was granted and the stock appreciation right does not otherwise include any feature that would permit the deferral of compensation.

  Second, a stock appreciation right granted after October 3, 2004 will not be considered deferred compensation if, in addition to the above two rules that apply to stock appreciation rights granted on or before October 3, 2004, the employer's stock is publicly traded and the stock appreciation right is settled only in such stock (not cash).

- 457(f) Plans. The Notice confirms that nonqualified deferred compensation plans of tax-exempt organizations and state and local governments established under Section 457(f) of the Internal Revenue Code (pursuant to which taxation cannot be deferred beyond the date of vesting) are subject to the requirements of the Act. However, length-of-service awards to bona fide volunteers are exempt from the Act's coverage by the Notice.

- Partnerships. Until the Internal Revenue Service issues additional guidance, plans providing for the issuance of partnership interests (including profits interests) or options to purchase partnership interests in connection with the performance of services (to partners or employees) are subject to the same rules as issuances of stock and stock options. Generally, this means that nondeferred issuances of partnership interests will not be subject to the Act and options to acquire partnership interests at or above fair market value on the date of grant will not be subject to the Act.

- Service Providers. Arguably, the Act could be interpreted to cover deferred compensation in any service relationship, commercial or otherwise, even relationships between business entities. However, the Notice gives a narrower reading to the Act so that it generally only covers services provided by individuals or by entities that are substitutes for individual service providers. In this regard, the Notice states that the Act applies only where the service provider is (i) an individual, (ii) a personal service corporation, (iii) a noncorporate entity that would be a personal service corporation if it were a corporation, (iv) a qualified personal service corporation, or (v) a noncorporate entity that would be a qualified personal service corporation if it were a corporation.

  The Notice also states that the Act does not apply to arrangements between a service provider and a service recipient if (i) the service provider is actively engaged in the trade or business of providing substantial services other than (A) as an employee or (B) as a director of a corporation and (ii) the service provider provides such services to two or more unrelated service recipients. This exception should cover most commercial relationships.

PAYMENT RULES

The Notice contains a few rules related to the timing of deferred compensation payments.

- Definition of Change of Control. The Act restricts payment of deferred compensation to a number of specified events, which include, among other things, a change in ownership or effective control of the employer or a change in the ownership of a substantial portion of the assets of the employer. The Notice provides detailed definitions of these terms and rules concerning the termination of a plan following a change of control, which are beyond the scope of this Alert.

- Permitted Accelerations. The Act generally prohibits an acceleration of the payment of benefits prior to the date otherwise established under an NDCP. However, the Act permits the Internal Revenue Service to create exceptions to this rule. The Notice contains several such exceptions, including for the payment of benefits in connection with a domestic relations order, the payment of taxes resulting from the taxation of deferred compensation under a Section 457(f) plan, cashouts of plan benefits by December 31 of the year in which an employee separates from service (or within 2-1/2 months after the end of such year) in amounts of up to $10,000, and the payment of payroll taxes applicable to deferred compensation.

REPORTING AND WITHHOLDING

The Notice contains a number of rules regarding the reporting of, and payroll and income tax withholding from, deferred compensation. These rules are beyond the scope of this Alert.

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