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Presentation on

# **Understanding the Nonqualified Deferred Compensation Guidance**

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- Daniel L. Hogans is with the Office of Benefits Tax Counsel in the U.S. Department of Treasury; however, today he is with us speaking in his individual capacities and the opinions he expresses here are his personal opinions and not the position of the Internal Revenue Service, the U.S. Department of Treasury or of any government agency. None of the comments should be considered official guidance or the position of any agency.
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## **An Overview Of the Deferred Compensation Rules under the American Jobs Creation Act of 2004 (“AJCA”) and the First Wave of Guidance**

### **What is deferred compensation?**

- Earned today and
- Paid in a future year (presumably when the income would be subject to a lower tax rate) or **in other words-**
- Legally binding right to compensation in year 1 that is not actually or constructively received, **and**
- Not paid to the service provider until a later year (more than 2½ months after the year end for year 1)

## Basic New Rules

- Why we care:
  - Violation brings tax of full amount deferred for the individual including all amounts accrued
  - Violation brings an additional tax of 20% on the full amount deferred with all accruals
  - Interest penalty recalculated with a 1% increase in rate on tax on amounts deferred in each prior year on accruals
  - Employers have reporting and withholding requirements

## Basic New Rules

- Distributions limited to certain specified events with delay for key employees
- New election content and timing rules
- Acceleration of benefits is prohibited
- New second or subsequent election rules
- Other rules for special offshore trusts and springing trusts in financial troubled times

## What is deferred compensation?

- Earned today and
- Paid in a future year (presumably when the income would be subject to a lower tax rate)
- No elective deferral by an employee is required
- It can be fully funded by the employer

## Where can you find deferred compensation?

- SERPs and other nonqualified plans
- Employment agreements with perks that are paid post termination
  - insurance benefits continued for 3 years
  - liability insurance
  - change in control plans
  - severance plans for executives
- Certain stock compensation

## What is not covered by the new rules?

- Qualified plans
- IRAs
- 403(b)
- Bona fide sick, vacation and compensatory time off
- Death benefits
- Disability pay

## What is not covered by the new rules?

- Stock options issued with an exercise price equal to the fair market value of the stock at the date of grant
- Short term deferrals
- Certain SARs
- ISOs and Employee stock purchase plans that qualify
- Restricted property
- Severance plans only for non-key employees
- Severance paid only for involuntary terminations
- Welfare benefits (medical plans that meet the Code's requirements for non-discrimination)

## When is an amount earned and vested?

- Legally enforceable right to receive the amount, it may be subject to a contingency
- Cannot be subject to employer's discretion to reduce the amount
- Amount to be received is established and no further actions of the individual are necessary to receive it
  - Change triggered in plan formula is okay
  - Change in amount caused by substantial risk of forfeiture is permissible

## Bonus Plans

- Bonuses are often earned in one year and payable in the following year after the corporation's tax year end the amount is set and cannot be reduced at year end. If they are paid within 2 ½ months of the employer's year end, they are not deferred compensation
- If the 2 ½ month window is missed and the employee is not certain what amount they will receive until the date it is paid to him because it can be changed until the date it is paid, will it still be deferred compensation?

## Substantial Risk of Forfeiture

- Non-compete agreements do not work
- Require continued substantial services
  
- SRoF conditions must be enforced in operation

## 3 Types of Plans

- Account plans include plans with a participant having an account balance that provides benefits in a manner similar to the way a qualified 401(k) plan operates,
- Non-account balance plans provide benefits that are more in the nature of a pension plan,
- "Other plans," what is covered by the other plans? stock compensation, other promises. . .

## Elections

- Initial election
  - must include the election as to the form of the distribution
- Performance based compensation
- Annual election
- There are also election rules to change the time or form of distributions and new requirements that must be met for these.

## Mirror or Wrap Plans and Elections

- Under the new rules can an election regarding an individual's benefit under a qualified plan that effects his benefit under the non-qualified deferred compensation plan (such as where the non-qualified plan's benefit is offset by the amount accrued in the qualified plan) be permitted?

## Distribution Rules and Acceleration Prohibition

- Distribution rules
  - Non-key employees
  - Key employees- 6 month wait after separation from service
  - Termination of employment, death, disability as defined by new law, unforeseeable emergency, specified time or fixed schedule, change in control
- Prohibition on acceleration of benefits

## Severance or RIFs

Payment for involuntary separation permissible

Severance paid from plan that only benefits non-key employees is permissible

## Grandfathered Plans

- In existence October 3, 2004
- Benefits accrued as of December 31, 2004
- No Material Modifications after October 3, 2004
- Old law applies
- Plan does not require a document called a Plan
- Violation of Material Modification prohibition impacts all participants in plan

## Consequences of Failure

- What happens when a non-qualified plan fails to meet the new requirements? Is it disqualified?
- **What are the consequences?**
  - Plan benefits for all similar types of plans are taxable in full
  - Plans' benefits including prior year accruals are subject to additional 20% tax
  - Interest at the underpayment rate plus 1% on tax on accruals in prior years

## Failure and Accruals

Violation in 2007	2004	2005	2006	2007
Annual Accrual	\$100,000	\$100,000	\$100,000	-\$200,000
Total Accrued Benefit	\$1.3 mill	\$1.4 mill	\$1.5 mill	\$1.3 mill
Accrued benefit taxed at violation				\$1.3 mill
Interest penalty calculated on	Tax on \$100,000	Tax on \$100,000 or 0?	Tax on \$100,000 or 0?	

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## Executive Agreement Perks

- Continued health benefits only available to exec
- Continued welfare benefits only available to exec
- Continued insurance for E & O, D& O or other liability, such as fiduciary policies on a claims made basis
- Interaction with 6 month wait post termination of employment

## SARs- Existing that work

- In effect on October 3, 2004
- With an exercise price that can never be less than the fair market value of the underlying stock on the grant date
- The receipt, transfer or exercise of the SAR is subject to tax under Code section 83 and
- The SAR does not include any feature that provides for the deferral of income from the grant date until the exercise date

## SARs- New that work

- Issued by a public company based upon its publicly traded stock
- Exercise price can never be less than the fair market value of the underlying stock on the grant date
- The SAR must be settled in such stock, and
- The SAR does not include any feature for the deferral of compensation other than the time between the SAR grant and exercise (such as a separate right to put the stock immediately back to the company for cash)

## Stock Appreciation Rights

- For private companies, there are no SARs that can be issued after December 31, 2004 unless they comply with the requirements of 409A
  - Exercise date set with in specified period locks in difference
  - Difference locked in at exercise can not be distributed until a date certain, such as the expiration of the SAR

## Stock Compensation

- Notice 2005-1 provided a number of clarifications regarding stock compensation, including that ISOs and Employee Stock Purchase Plans under Code section 423 and non-qualified or non-statutory options issued at Fair Market Value are not deferred compensation as long as there are no additional deferral features. What are the kinds of deferral features that could bring such an arrangement within the deferred compensation statute's reach?

## Problematic Deferral Features for SARs

- Separate put rights for a SAR exercised in Company stock that permits the individual to sell the stock received back to the company at the current FMV
- Similar arrangements directly or indirectly that provide cash promptly following exercise to circumvent the exercised only for company stock requirement

## Grandfathered SARs

- Earnings on deferred compensation that is grandfathered are part of the grandfathered amount
- What are earnings on a SAR's value that is grandfathered as of 12-31-04? Q/A 17 says appreciation on equity compensation is earnings

## Determining FMV

- Currently, any reasonable method
- The rules for determining FMV for estate tax purposes
  - Will discounts apply, such as minority interest?
- ISO valuation rules were not selected

## Promises to Issue in Future

- Restricted Stock- promise to issue restricted property or restricted stock in future is not deferred compensation
- Promise to issue stock option in future is not an option grant, so exercise price cannot be set at promise because it is not the FMV at the date of grant

## Change in Control

- Guidance only addresses single triggers
- Double triggers that pay too far from the change in control may be problematic if there is not another distribution option

## Considerations in Applying the New Transition Rules

## Documenting Grandfathered Status

- Plan as in effect on October 3, 2004 and proof of adoption
- Proof no material modification
- Proof of amount accrued as of 12-31-04
- Proof of earnings post 12-31-04
- Proof of operations for all periods

## Material Modifications

- No new benefits, but if you customarily grant stock compensation in November or December, continuing to do similar grants in 2004 should still be grandfathered
- Document grants in a number of recent years
  - type
  - amount
  - to whom
  - terms and conditions

## Required Plan Amendments

- December 31, 2005, but the plan must operate in compliance with the new requirements for all periods after December 31, 2004
- Operational compliance must be documented

## Plan Amendment Deadline

- December 31, 2005

## Operational Compliance

- Must operate in compliance with the new law and existing guidance
- New restrictions are not likely to match current plan provisions or operations so you will need to say no when someone may believe they have a contractual right

## Deferral Election Relief

- For services performed prior to January 1, 2006,
  - Individuals may make elections until March 15, 2005, provided the election only applies to amounts payable after the election, and
  - Provided the plan is amended in a timely manner, and
  - Provided there was a written plan in existence before 2005

## Termination Option

- Applies to grandfathered plans terminated on or before December 31, 2005 and distributed by same date
  - Avoids the 20% penalty tax
  - Avoids the interest on tax related to amounts that were deferred in prior years
  - Does not permit the employees to elect on an individual by individual basis, employer discretion only

## Reporting Requirements

- Annual deferrals (accruals) of deferred compensation reported on W-2 (in box 12 with a Y code) for employees, and
- Report on Form 1099-Misc for others (box 15a) for whom at 1099-Misc is required to be filed,
- Annual deferral reporting is required unless the amounts are not reasonably ascertainable
- Prior reporting requirements for Box 11 are still in effect

## Reporting Requirements

- Amounts less than \$600 for now do not need to be reported on a W-2
- Effective for amounts deferred after 12-31-04
- Earnings on deferrals after 12-31-04 must also be reported

## Reporting Requirements for Violations

- The full amount accrued must be reported as gross income and wages in box 1 of Form W-2, and
- It also must be reported in box 12 on Form W-2 with a code Z

## Withholding Requirements

- Amounts that are taxable because they violate the new nonqualified deferred compensation rules are subject to income tax withholding even if no cash is received or constructively received
- For 2005 amounts that are income from a 409A violation even though the employee does not actually or constructively receive the amount are treated as paid on 12-31-05 (for purposes of determining when to deposit the payroll taxes) (You can treat them as included earlier)

## More Guidance to Come?

YES

Many thanks to Dan Hogans for  
illuminating us on these tough  
issues.



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## Questions?



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