CCH®

VOLUME 13, NUMBER 5
DECEMBER 2004

THE M&A Tax Report

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES



# Deferred Compensation Provision of the Jobs Act

**By Robert W. Wood • San Francisco**

Much of the hoopla surrounding the enactment of the American Jobs Creation Act of 2004 [P.L. 108-357] involves foreign provisions of the Internal Revenue Code. Nonetheless, one of the most far-ranging changes in the Jobs Act is a series of new rules that will significantly affect executive compensation arrangements. These include fundamental changes to nonqualified deferred compensation plans; a limitation on deductions for personal use of employer-provided airplanes; permanent withholding relief for incentive stock options, as well as for options under Code Sec. 423 employee stock purchase plans; and an increase in withholding for supplemental wage payments in excess of $1 million.

My focus here is only on changes to nonqualified deferred compensation plans. This is a sweeping set of changes, some of which have already engendered debate as to exactly what the provisions mean. We now have a new Code Section: 409A. It is a doozie. One good thing (at least) is that these new and difficult provisions are effective only for amounts deferred in tax years beginning after December 31, 2004. Of course, there are transitional rules (aren't there always?) that complicate this effective date materially.

## Deferred Comp Basics

Under pre–Jobs Act law, an unfunded nonqualified deferred compensation arrangement results in the compensation generally being includable in income when it is either actually or constructively received. Income is constructively received when it is credited to an individual's account, set apart or otherwise made available so that it can be drawn upon. Conversely, there will be no constructive receipt where the taxpayer's control of its receipt is subject to substantial

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limitations or restrictions. Timing is extremely important, and timing is one of the key elements affected by the Jobs Act.

Up until now, elections to defer compensation could generally be made at any time when the compensation is payable. Likewise, payment of a nonqualified deferred compensation arrangement can be accelerated on specified events, or at any time, if the early payment is subject to a penalty or other substantial limitation. Redeferrals and changes in the form of payments, not surprisingly, are generally not allowed.

## New Deferral Regime

The Jobs Act imposes numerous requirements on nonqualified deferred compensation plans, reflecting Congress' (and the IRS') serious concerns with many deferred compensation arrangements. Significantly, if these new rules are not satisfied, all compensation which has purportedly been deferred under the plan will be includable in the participant's gross income to the extent this compensation is not subject to a substantial risk of forfeiture.

As if this were not enough, the participant will also be required to pay interest (at the tax underpayment rate plus one percentage point) and will incur a 20-percent penalty on the amount required to be included in income. If a particular requirement affects only some of the plan participants, then current income inclusion, interest and the additional tax will apply only to those participants.

Perhaps of greatest practical significance, the timing of the deferral election must be substantially earlier under the new law. Indeed, for amounts deferred in tax years beginning after December 31, 2004, an initial election to defer compensation for services under a nonqualified deferred compensation plan must be made in a year *before* the year in which the related services were performed. For bonuses that relate to services provided over one or more years, this provision would seemingly require any deferral election for such bonuses to be made *before* any of the services are performed.

Still, the new law includes a little bit of flexibility here. In the case of any performance-based compensation that is based on services performed over a period of at least 12 months, this initial deferral election can be made no later than six months before the end of the service period. The IRS is directed by the statute to issue regulations that define performance-based compensation for this purpose to be compensation that is (1) variable and contingent on the satisfaction of pre-established organizational or individual performance criteria; and (2) not readily ascertainable at the time of the election. These requirements are intended to be similar to those applicable under Code Sec. 162(m), governing the $1 million deduction limitation for compensation.

The new law permits an election to delay the timing, or change the form, of distributions. However, this type of election cannot take effect for at least 12 months, and must be made at least 12 months before the first scheduled payment. As if this limitation were not enough, any such "redeferral" must be made for at least an additional five years.

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH INCORPORATED, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com. 

## Other Provisions

In addition to initial elections and redeferrals, the new nonqualified deferred compensation rules address the distribution timing rules. Compensation deferred under a nonqualified deferred compensation plan now generally cannot be distributed earlier than separation from service, disability, death, a specified time or under a fixed schedule, or in the case of an unforeseeable emergency. The acceleration of distributions is not permitted, except as may be provided by regulations. A distribution resulting in the change in ownership or effective control of the employer may be allowed only as provided by IRS regulations. For key employees of a publicly traded company, there would be a six-month waiting period for any distribution made on account of any separation from service.

Off-shore trusts as funding mechanisms for nonqualified deferred compensation plans are also targeted. Assets that are set aside directly or indirectly in an off-shore trust are generally considered to be property transferred in connection with the performance of services under Code Sec. 83. Thus, such amounts are included in a participant's gross income as soon as the participant's interest in the assets is vested. This rule does not apply, however, to assets located in a foreign jurisdiction if substantially all of the services related to the nonqualified deferred compensation are performed in that foreign jurisdiction. This provision contains a similar rule if nonqualified deferred compensation assets become restricted to the payment of benefits on a change in the employer's financial health.

## Options

The new rules define a nonqualified deferred compensation plan for purposes of the new restrictions so as to *exclude* a nonstatutory stock option plan under which options are granted at no less than the fair market value of the stock on the date of the grant, and under which there is no deferral feature other than the right to exercise the options in the future. Thus, the typical nonqualified stock option plan is exempt from these rules. Similarly, a nonqualified deferred compensation plan also does not include an incentive stock option that is qualified under Code Sec. 422, nor an employee stock purchase program that is qualified under Code Sec. 423.

However, the term "nonqualified deferred compensation plan" presumably does include nonqualified stock options that are granted at a discount, or that provide a deferral feature. Likewise, a nonqualified deferred compensation plan would include a plan calling for stock appreciation rights. Because stock appreciation rights are typically exercisable at any time during a specified exercise period, the new set of rules could have a significant effect on the design of many stock appreciation rights plans.

## Effective Date of the Rules

These provisions generally apply to amounts deferred in tax years beginning after December 31, 2004. However, earnings on amounts deferred *before* the effective date are subject to the provision to the extent that those amounts deferred are subject to the new rules. Amounts deferred in tax years beginning before 2005 are subject to the new rules if the plan under which the deferral is made is materially modified after October 3, 2004.

A plan that satisfies current law and that is not materially modified after October 3, 2004, can still be operated under the old law rules. Thus, redeferrals for amounts originally deferred before 2005 under a plan that is not materially modified after October 3, 2004, would not be subject to the new rules. These grandfather rules obviously hinge on what constitutes a "material modification."

The Jobs Act indicates that a material modification would be the addition of a benefit, right or feature. Thus, adding an early distribution provision, or a provision accelerating vesting under a plan after October 3, 2004, would be considered a material modification, thus triggering application of the new rules even to pre-2005 deferrals. Furthermore, an amount would be considered deferred before 2005 only if it is both earned and vested for that year. Thus, nonvested benefits earned before 2005 are subject to the new rules.

Finally, note that the acceleration of vesting is a material modification, thus causing the loss of grandfather status for all pre-2005 deferrals. As a result, employers will not have the ability to accelerate vesting of any nonvested benefits to bring them within the grandfather relief.

Regulations are supposed to be issued by the IRS (believe it or not, within 60 days after the date of enactment) for those plans adopted by December 31, 2004. The regulations are to provide a limited period in which the plans either (1) can be amended to permit termination of participation or cancellation of outstanding deferral elections; or (2) can be amended to conform to the new rules for amounts deferred after 2004.

## Now, It Begins ...

Many of the implications of the new set of deferred compensation rules are not yet clear. Yet, some obvious changes are already underway. Clearly, the great flexibility that both employers and employees have enjoyed with respect to nonqualified deferred compensation plans is waning. Indeed, there are now significant restrictions placed on plan design, as well as on the ability of participants either to access their funds or to change the timing of amounts.

Most frequently, nonqualified deferred compensation plans have allowed participants to change either the time or form of benefit payments (or both), and to do so multiple times before the benefits first become payable. Acceleration of benefit payments is also quite typical with a list of specified events that is normally not too onerous. Likewise, many plans have traditionally simply imposed some kind of penalty on early withdrawals.

Elections are often allowed under plans between lump-sum and periodic payments. All of this flexibility has (in most cases anyway) been possible without risking current taxation of the amounts. Much of this flexibility is simply gone at least for plans and deferrals covered by the provisions (generally, deferrals after December 31, 2004).

What does that mean as a practical matter? Just about every nonqualified deferred compensation arrangement will need to be amended, if not entirely revamped. In addition, given the basic effective date of December 31, 2004, every plan, arrangement or employment contract that provides nonqualified deferred compensation should probably be reviewed.

## Caution

There is already a groundswell of concern about what all of these nonqualified deferred compensation rules will mean. For example, stock options with a deferral feature may be in jeopardy. After all, stock options with permissible deferral constitute performance-based compensation, assuming the compensation was based on services performed over a period of at least 12 months.

Presumably, therefore, an initial deferral election can be made no later than six months before the end of the service period. This obviously raises a question about just when the "service period" ends. One could argue that the service period ends at the time of the exercise of the stock option. But is this correct?

Of course, it also isn't clear what a performance-based bonus might be. What about the definition of "separation from service"? This seems like an obvious one, but sometimes it is not. It isn't even clear what a nonqualified deferred compensation plan encompasses for purposes of the new rules. Restricted stock arrangements, for example, may or may not constitute such a plan.

There will be considerable focus on not making any material modification to old plans, and yet necessarily, to creating new plans too so deferrals under the new plan will not taint those under a grandfathered plan. It will be an interesting dance. The new deferred compensation provisions of the Code rank as some of the more important and sweeping provisions enacted in the Jobs Act.