

IRS EASES TRANSITION INTO NEW DEFERRED COMPENSATION RULES

The IRS has issued its eagerly awaited guidance on the new nonqualified deferred compensation rules (IRC Section 409A) created under the American Jobs Creation Act of 2004 (AJCA). The good news for employers is that this first transitional guidance (Notice 2005-1) allays any concerns over having to amend plans, change deferral elections or implement resolutions by the end of this year. The IRS has made it clear that although plans should be operated in good faith compliance with the new rules throughout 2005, plans do not have to be amended and initial elections as to time and form of payment do not have to be made until the end of 2005 (although they will be generally retroactive to January 1, 2005).

NOTICE 2005-1

Some important highlights of the new guidance include –

- **Stock Options.** Typical, at-the-money stock options are excluded from the category of nonqualified deferred compensation – as long as the exercise price is not permitted to drop below the stock's value on the date of grant and there is no "exercise gain" deferral feature.
- **SARs.** The guidance provides a safe harbor exemption for non-discounted stock appreciation rights (SARs) – as long as the employer stock is traded on the established securities market, the SARs are settled in employer stock, and they do not include any deferral of compensation feature. Also, until further guidance is issued, both cash-settled and stock-settled SARs granted under programs in effect on October 3, 2004 are exempt if they are not discounted and do not have a deferral feature.
- **Short-term Deferrals.** The guidance confirms that short-term deferrals are not subject to Section 409A.
- **Long-Term Compensation.** Most common long-term incentive opportunities will be exempt from the new requirements provided the earned compensation is paid out within 2-1/2 months following the close of the first taxable year in which the pay or award vests and there is no opportunity to delay receipt. It appears that restricted stock units, performance shares, and other commitments to issue company stock at a pre-set future date should be exempt under this rule as well.
- **Bonus Compensation.** Bonuses (both annual and multi-year) may be deferred pursuant to an election up to 6 months before the end of the service period (of 12 or more months) to which the bonus relates. Bonuses eligible for these elections must be contingent on the satisfaction of organizational or individual performance criteria that are not substantially certain to be met at the time of deferral. The performance criteria may be subjective, provided the determination of whether they are met is not made by the individual

or a family member. SARs and other compensation based solely on the value of stock do not qualify for this treatment.

- **Grandfathered Amounts.** The guidance provides a method of identifying grandfathered amounts under nonqualified deferred compensation plans. With respect to a SERP or other nonindividual account arrangement, the grandfathered amount equals the present value, as of December 31, 2004, of the amount that the individual would be entitled to if that individual voluntarily terminated on December 31, 2004 and received full payment of benefits at the earliest possible date allowed under the plan. In the case of a defined contribution plan, the amount earned and vested on December 31, 2004 is grandfathered. An amount is “earned and vested” only if it is not subject to either a substantial risk of forfeiture (as defined under IRC Section 83) or a requirement to perform future service. In most cases, bonuses earned in 2004, but payable in 2005 would not be entitled to grandfather treatment.
- **Material Modifications.** Under AJCA, grandfathered amounts deferred prior to January 1, 2005 are exempt from the new requirements only if the plan or arrangement under which these deferrals have been made has not been "materially modified after October 3, 2004." According to Notice 2005-1, a material modification occurs if, after this date, an existing benefit is enhanced or a right is added. Further, the guidance clarifies that amending a plan to conform to the new rules with respect to nongrandfathered amounts does not constitute a material modification, provided it does not enhance or create a new right or benefit for grandfathered amounts (even one that is permissible under the new rules). For example, the removal of an impermissible haircut provision would not be a material modification of a plan, but adding a right to a distribution of grandfathered amounts upon an unforeseen emergency would be a new right that would constitute a material modification.
- **Payment Elections.** Elections as to form and timing of distributions may be made through December 31, 2005 with respect to amounts subject to the new rules and deferred prior to the date of election. Plans must be amended to allow for these election changes.
- **Mirror Plans.** Payments from SERPs and excess benefit plans that "mirror" the timing and form of payment under a qualified plan will be permitted for periods ending on or before December 31, 2005 – as long as made in accordance with a plan that was in effect on October 3, 2004.
- **No Relief for Key Employees.** Key employees are not allowed to receive deferred compensation payments subject to Section 409A for at least 6 months after they terminate employment for reasons other than death or disability. The notice does not provide any relief from this rule for 2005.

- **Late Deferral Elections.** For plans in existence on December 31, 2004, deferral elections that are made by March 15, 2005 for amounts that are not yet paid (or payable as of the date of the election) will not be subject to the Section 409A timing rules.
- **Right to Cancel Deferral.** Plans adopted prior to December 31, 2005 may be amended to provide that a participant may cancel or reduce deferral elections applicable to amounts deferred after December 31, 2004 and subject to Section 409A up to December 31, 2005. The amounts subject to cancellation must be includable in income in the year earned and vested (in 2005 or later years). This provision need not apply equally to plan participants.
- **Plan Terminations.** A plan sponsor can accelerate vesting and terminate (and make distributions from) a pre-October 4, 2004 arrangement by December 31, 2005 without it being deemed a material modification of the plan and thus, subject to Section 409A.
- **Severance Plans.** Although severance plans are subject to the new rules, certain severance plans are exempt for 2005 (i.e., those that meet DOL requirements, cover collectively bargained employees or cover no key employees, and pay benefits only in the case of involuntary termination). However, these plans must be amended by the end of 2005.
- **Penalties.** The guidance indicates that plans will be aggregated by type – i.e., account plans, equity plans and defined benefit plans – for purposes of assessing penalty taxes.

Final Notes

There is of course much more in the guidance than is summarized here. Also, it should be noted that Notice 2005-1 is only the first installment of guidance and many issues (e.g., treatment of foreign plans and trusts, who are key employees) are not addressed. Suffice it to say that for now, employers can generally breathe a sigh of relief with respect to their existing arrangements. We will follow up with a more comprehensive *For Your Information* early next year.

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