AALU's Washington Report

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Subject: **New Deferred Compensation Rules - Additional Analysis**

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The President signed the American Jobs Creation Act of 2004 on October 22, 2004. This new law makes dramatic changes to the tax rules for virtually all nonqualified deferred compensation arrangements (see our Bulletins Nos. 04-139, 04-135 and 04-133). Because the new rules are generally effective for amounts deferred on or after January 1, 2005, employers must react and adapt quickly to the new rules. The Internal Revenue Service and Treasury are expected to issue guidance within the next six weeks which will address certain transition issues and clarify some of the substantive provisions. Based on our informal discussions with representatives from the Internal Revenue Service and the Treasury since the enactment of the new rules, we have additional insight into the direction they are leaning on a number of issues, which are summarized in this bulletin.

I. *Background*

The new rules generally apply to any agreement or arrangement (including those covering only one person) that provides for the deferral of compensation. Certain tax-favored retirement plans (e.g., qualified retirement plans, 403(b) plans) and bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans are expressly excepted from the new rules. In the guidance to be issued in the next few weeks, the Internal Revenue Service and Treasury are also expected to exempt incentive stock options (Code section 422), employee stock purchase plans (Code section 423) and bonuses paid within 2-1/2 months after the end of the bonus period.

The new rules impose three new key requirements, which must be satisfied both in form and operation: (1) distribution restrictions, (2) acceleration restrictions, and (3) election restrictions. The new requirements are in addition to the existing rules, and do not replace them. As a result, a deferred compensation plan will need to satisfy both the new rules and the existing rules (e.g., constructive receipt, economic benefit, and Code section 83 rules, to the extent applicable).

The distribution restrictions provide that deferred compensation cannot be distributed any earlier than one of six specified events - (1) separation from service (six months after separation from service for key employees of publicly-traded companies); (2) disability (as narrowly defined in the statute); (3) death; (4) a specified time (or fixed schedule) specified under the arrangement as of the date of deferral, but not an event; (5) a change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation (to the extent provided by the Treasury); or (6) the occurrence of an unforeseeable emergency (as narrowly defined in the statute).

The acceleration restrictions provide that the deferred compensation cannot be accelerated except as otherwise provided in regulations. For example, so-called "haircut" provisions, which allow for the accelerated distribution of deferred compensation if there is a reduction in the amount payable (e.g., 10% reduction), would no longer be permissible.

The election restrictions impose requirements with respect to both the timing of a participant's initial deferral election as well as the designation of the time and form of distributions. With respect to a participant's initial deferral election, the initial election to defer compensation for services performed during a taxable year must generally be made no later than the close of the preceding taxable year. There are two statutory exceptions. First, in the case of a new plan or a participant first becoming eligible under a plan, the initial deferral election must generally be made within 30 days of initial eligibility; in this case, the election may relate only to compensation for services performed after the date of the election. Second, the deferral election with respect to "performance-based compensation", which remains to be defined by the Internal Revenue Service and Treasury, can be made up to 6 months before the end of the performance period, provided the performance period is at least 12 months.

Under the new rules, the time and form of distributions must be designated at the time of the initial deferral election. However, the new rules allow for changes that further delay or change the form of payment if all of the following requirements are met: (1) the change does not take effect until at least 12 months after *the date on which the election to change is made*; (2) in the case of payments made on account of separation from service, a specified time (or pursuant to a fixed schedule), or following a change in control, the first payment with respect to which the change is made must be deferred for at least 5 years from *the date the payment would otherwise have been made*; and (3) in the case of any change related to a payment made on account of a specified time (or pursuant to a fixed schedule), the change cannot be made less than 12 months before *the date of the first scheduled payment.*

The legislation also imposes new rules regarding the funding of deferred compensation arrangements. Assets that are located outside of the United States would generally be taxable to the participants when transferred outside of the United States or set aside. Assets that become restricted to the payment of deferred compensation in connection with a change in the employer’s financial health would be taxable to the participants at the earlier of the time when the plan first includes such a restriction or when the assets become so restricted (whether or not the assets are available to satisfy the claims of general creditors). In addition, the new rules require all deferred compensation to be reported on IRS Form W-2 or Form 1099 when deferred, even though the compensation may not yet be taxable.

There are significant adverse tax consequences if the new requirements are not satisfied: (1) all deferred compensation must be included in income in the current taxable year to the extent not subject to a substantial risk of forfeiture (including deferrals in prior years); (2) an additional tax equal to the interest, using the Internal Revenue Service's underpayment rate plus 1%, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or not subject to a substantial risk of forfeiture); and (3) an additional tax equal to 20% of the deferred compensation.

The new rules generally apply to amounts deferred (and vested) on or after January 1, 2005. Amounts deferred (and vested) before January 1, 2005, will not be subject to the new rules unless there is a material modification to the deferred compensation arrangement on or after October 3, 2004.

II. *Additional Insights*

We have had discussions with representatives of the Internal Revenue Service and the Treasury with respect to their current thinking on a number of the issues raised by the new rules. The discussions and their thoughts are summarized below. However, we must caution that these are only preliminary, informal indications; any of the points discussed below could be reflected in a different fashion in forthcoming official guidance.

A. Scope of the Guidance to be Issued

The legislation requires the Internal Revenue Service and Treasury to issue transitional guidance within 60 days of enactment (i.e., by December 21, 2004) and guidance with respect to the change in control rules within 90 days (i.e., by January 20, 2005). We understand that the government has been working on the guidance for several months in anticipation of the passage of the legislation and is expected to issue a single set guidance on or before December 21, 2004. The guidance will address transition issues as well as certain substantive issues, including the change in control guidance.

B. Transition Issues to Be Addressed in Guidance

1. Relief to be provided. Government officials recognize that employers and other sponsors do not have a lot of time to react and adapt to the new rules. Accordingly, they are indicating that there will be significant transitional relief in certain areas. For example, with respect to the deferral election timing rules, the government representatives are indicating that employers should continue to operate their existing arrangements as they have in the past, assuming, of course, that prior operations complied with the pre-existing requirements. If so, employers will be given an opportunity to "correct" or modify their arrangements during a transition period to comply with the new rules. In addition, the government is expected to relax some of the rules during the transition period. For example, the deferral elections for 2004 bonuses payable in 2005 would ordinarily have to have been made before 2004 under the new rules (i.e., before the year in which the services were performed). In many cases, existing bonus deferral arrangements do not require the deferral elections to be made until the end of the calendar year before the year of payment (i.e., before the end of 2004 for bonuses paid in 2005). The government is expected to issue transition relief

for such 2004 bonus deferral elections, which will accept elections made by the end of 2004 for bonuses paid in 2005.

The government is also expected to provide transition relief for 2005 bonuses payable in 2006. Again, under the new rules, the deferral elections would ordinarily be required to be made before the beginning of 2005 (i.e., the year the services are performed). The government is expected to issue transition relief that will allow participants to make deferral elections for 2005 bonuses payable in 2006 during the applicable transition period, whether or not the bonuses qualify as "performance-based compensation."

The transition period is expected to extend for at least 3 months and possibly as many as 6 months. In addition, employers may be given additional time to formally amend their plan documents to comply with the new rules (although operational compliance may be required earlier).

2. Unwind rule. The transition relief is also expected to allow employers and participants to "unwind" deferral arrangements during the transition period for amounts subject to the new rules. Thus, in a worst case scenario, if employers and/or participants do not want to modify their existing arrangements for amounts subject to the new rules, they should be able to unwind the transition period deferrals and include the amounts in income when earned without the additional interest and 20% taxes.

The government officials have indicated that they do not want to penalize employers and participants for actions that they may have taken without knowledge of the new rules, and therefore, the transition relief will potentially provide various options in response to the guidance (e.g., relaxed rules during the compliance period, retroactive modifications to comply, and the ability to unwind with respect to amounts deferred on and after January 1, 2005). The government is referring to this as the "no clairvoyance" doctrine - employers and participants will not be expected to have complied with new rules that they were not aware of because the laws were enacted late in the year, and, in many respects, remain unclear.

3. Reasonable, good faith? It is not clear whether the government will adopt a reasonable, good faith compliance standard during the transition period. This standard has been applied many times in the past with respect to changes in the law. Although the legislative history does not discuss adopting such a standard during the transition period, it appears to grant the Internal Revenue Service and Treasury the authority to establish such a standard, particularly with respect to substantive issues that may not be addressed in the first set of guidance.

C. Scope of Arrangements Covered under the New Rules

1. Broad coverage. The new statutory rules apply broadly to any agreement or arrangement that provides for the deferral of compensation. This would appear to apply to arrangements between an employer and employee, a service recipient and service provider (including services provided by independent contractors such as life insurance agents), and possibly other arrangements including agreements between entities or individuals that do not necessarily involve services (e.g., sale of goods, settlement agreements between litigants). Given the importance of this issue, the Internal Revenue Service and Treasury are expected to address the scope of the arrangements covered in their first set of guidance.

The initial guidance is also expected to address the question of when an arrangement results in the deferral of compensation. The legislative history indicates that for purposes of the effective date provisions, an amount is considered deferred before January 1, 2005 (and therefore potentially grandfathered) only if it is both earned and vested before January 1, 2005. For example, if the election to defer compensation was made in 2003, but the executive must be employed on July 1, 2005, in order to be entitled to the deferred compensation (i.e., not vested until 2005), the amount is not considered deferred until July 1, 2005, and therefore, is subject to the new rules (even though the election to defer was made back in 2003).

2. Earned and vested standard - (option 1). Government officials have indicated that they are currently considering using the same "earned and vested" standard (or a variation thereof) for purposes of determining when an arrangement results in the deferral of compensation (i.e., not just for purposes of the effective date). For example, several government representatives have indicated that an arrangement may result in the deferral of compensation if it provides for compensation that is earned and vested in one calendar year, but paid in a subsequent calendar year. Under this standard, if a participant must perform additional services in order to obtain a nonforfeitable right, the compensation is not earned and vested until the service requirement is satisfied. Under such an approach, if the arrangement provides for the payment of the compensation in the same calendar year in which it vests, it would not result in the deferral of compensation and would not be subject to the new rules. For example, if an annual bonus arrangement provides for the payment of a bonus for a particular calendar year in the immediately succeeding calendar year, but requires the executive to be employed on the payment date in order to receive the bonus, the bonus is not earned and vested until the immediately succeeding year. If the bonus is actually paid in the immediately succeeding year, it would not result in the deferral of compensation and would not be subject to the new rules.

a. Deferred commissions of life insurance agents. The broad scope of the new rules would also potentially apply to deferred commission arrangements for life insurance agents, whether they are employees or independent contractors. Depending on the applicable standards ultimately adopted by the government, if a commission is earned and vested in one calendar year, and paid in a subsequent calendar year, the arrangement may be a deferred compensation plan that is subject to the new rules which, among other requirements, would mandate that any deferral election be made before the calendar year in which the services were performed and that the compensation be distributable only upon the occurrence of one of the acceptable distribution triggers. In addition, the time and/or form of distribution could be changed (e.g., re-deferrals) only if the specific requirements for such a change were satisfied.

b. Negative discretion. The government representatives have also indicated that, if the amount is subject to the negative discretion of any person or entity, it may not be earned and vested until the amount is fixed. For example, if an annual bonus plan provides an objective formula for determining the amount of a bonus depending on the financial performance of a company and one of its executives, but the compensation committee of the board retains discretionary authority to adjust the bonus up or down, including the right to decide not to pay any bonus, the bonus is not considered earned and vested until the compensation committee fixes the amount of the bonus that is payable.

2. Earned standard - (option 2). Government officials have said they are considering an alternative approach under which, instead of using the "earned and vested" standard described above, they would use an accrual-type standard (e.g., turning on when compensation is earned). That is, they could use an earned and vested standard for the effective date provisions and another standard for determining when an arrangement results in the deferral of compensation.

Similarly, they could use a different standard for applying the deferral election timing rules. The statute currently provides that the deferral election must be made before the calendar year in which the services are performed. Government officials have indicated that they are considering a number of different standards for this requirement, particularly for amounts paid for services performed over several years or for services performed in prior years for which the compensation is not earned until a later year. For example, government representatives have indicated that they are considering the rules that should apply to insurance renewal commissions which are payable on account of services in prior years, but which arguably are not "earned" until a later year. If the government adopts a standard based strictly on the statutory language, any deferral election would have to be made before the calendar year in which the services were performed -- arguably the year in which the insurance contract was initially sold. Alternatively, if the government were to adopt an "earned and vested" approach for the deferral election timing rules, the election would have to be made before the year in which the insurance agent obtains a nonforfeitable right to the commissions.

D. Grandfathered Arrangements

1. Material modification. The new rules do not apply to amounts deferred before January 1, 2005, unless the deferred compensation arrangement is "materially modified" on or after October 3, 2004 (i.e., the date of release of the House-Senate Conference document in which the material modification concept first appeared). For this purpose, the legislative history provides that a material modification will generally occur if there is an addition of a benefit, right, or feature to the plan. However, the legislative history also indicates that there will be no material modification if there is a reduction or exercise of an existing benefit, right or feature.

The government representatives have indicated that they intend to apply the term "material modification" broadly. Generally, if anything of value is added to an arrangement on and after October 3, 2004, there is a possibility that it will be treated as a material modification that would subject the previously-deferred compensation to the new rules and, possibly, the above-described adverse tax consequences if the requirements are not satisfied. For example, the government representatives have indicated that if an employer or plan sponsor exercises discretionary authority in a manner that provides an additional benefit or something of value, the exercise of such discretion may constitute a material modification even if the plan expressly provided for such discretion before October 3, 2004. As a result, employers and plan sponsors should now be extremely careful in making any modifications to existing arrangements.

The government representatives have also indicated that a material modification of an arrangement will potentially cause the entire arrangement to lose its grandfathered status. The legislation expressly provides that if the new requirements are not satisfied, only the participants with respect to whom the failure relates are subject to the adverse tax consequences. The government representatives have indicated that this participant-level concept does not apply for purposes of the material modification rules. One reason is that the material modification rules are intended to deter significantly any changes to an arrangement on and after October 3, 2004. If a material modification will impact the grandfathered status of an entire arrangement (and not just the affected participants), the thinking is that such a consequence should act as a serious deterrent to any material modifications.

With respect to the general participant-level rule for adverse tax consequences, the government officials have also indicated that there may be situations in which a failure, although technically applicable to only one participant (or a limited number of participants), may subject all of the participants to the adverse consequences. An operational failure to comply with the distribution restrictions was given as one example of this situation. The concern is that if the plan is modified operationally for any participant, it could be modified operationally for all participants.

Further with respect to the material modification provisions, the statutory language and legislative history provide that any such modification after October 3, 2004, would result in a loss of grandfather status for the arrangement. Government officials have indicated that the initial guidance may limit the scope of the material modification rule to those modifications that affect amounts deferred before January 1, 2005 (i.e., amounts that would otherwise be grandfathered). Thus, if an existing arrangement is changed after October 3, 2004, to modify the terms applicable to an amount deferred on or after January 1, 2005, it would not affect the grandfathered status of the plan with respect to amounts deferred before January 1, 2005.

2. Freezing and terminating plans. The government representatives have also indicated that the act of freezing an existing arrangement as of December 31, 2004, would not constitute a material modification. We have suggested in our Bulletin No. 04-133 that employers and plan sponsors may want to consider freezing existing arrangements as of December 31, 2004, to minimize the chances of an inadvertent material modification in the future (e.g., the plan is amended in 2010, and an amount deferred before January 1, 2005, is inadvertently materially modified). However, the government representatives have also distinguished between freezing a plan and terminating it followed by current distribution of the deferred compensation. Under their current thinking, a termination and distribution would be considered a material modification that would subject the plan to the new rules. Under those new rules, the distribution of the deferred compensation upon plan termination would violate the acceleration restrictions, and therefore, the deferred compensation would be subject to the adverse tax consequences described above. As a result, it appears that plan sponsors cannot terminate existing arrangements by the end of 2004 to avoid the new rules (or at least the potential application of the new rules if a grandfathered arrangement is ever materially modified in the future). The government is concerned that a termination and distribution could create a potentially abusive exception to the acceleration restrictions. The government representatives have indicated that they recognize that such a rule would effectively prohibit plan sponsors from shutting their plans down early for legitimate business reasons (e.g., when the employer goes out of business, following a merger or acquisition), but they are considering such a rule nonetheless.

E. Stock Appreciation Rights

There was a significant, and ultimately unsuccessful, lobbying effort to exempt stock appreciation rights ("SARs") from the coverage of the new rules. Government officials have indicated that they are not planning to provide any exceptions or relief with respects to SARs. However, the government representatives have acknowledged that certain modifications to SARs may work under the new rules. One of the features of SARs that makes it difficult for them to comply with the new rules is that they currently provide the holder with the discretion to exercise them at any time (i.e., to essentially control the timing of the income recognition). Under the new rules, the time of distribution must be designated in advance and must be one of the permitted distribution events, such as a specified date. Existing SARs would not meet this requirement because the holders can exercise them at any time. One possible modification to a plan would be to provide that a SAR holder can exercise the SAR at any time, but the appreciation would not be paid out until a specified date or at the time of a permitted distribution event (e.g., upon separation from service). This type of modification would give the executive the ability to control the timing of the measurement of the appreciation, but would arguably comply with the new rules because the appreciation would not be payable until one of the recognized distributable events occurs. The government representatives have indicated that this type of arrangement appears to comply with the new rules.

F. Severance Plans

As an example of the potentially broad coverage of the new rules, the government representatives have confirmed that severance plans are covered to the extent they result in the deferral of compensation. Severance plans were conspicuously left out of the exception for other "bona fide" welfare type arrangements (e.g., bona fide death and vacation pay plans). For example, if an individual is involuntarily terminated in November of 2005 and under the employer's severance plan is entitled to severance payments for 12 weeks, the arrangement arguably provides for the deferral of compensation because it results in the payment of compensation in a calendar year after the calendar year in which the compensation amounts were earned and vested (assuming that that is the standard ultimately adopted by the government for this purpose). Government officials have confirmed that such an arrangement may be covered and have indicated that they are considering an exception for broad-based severance arrangements (i.e., arrangements that cover the rank and file employees). However, they are concerned that if they provide any additional exceptions for severance arrangements (e.g., for executive severance agreements), it would create a significant potential for abuse. This concern is partly in response to their experience under Code section 457(f) (deferred compensation arrangements for governmental and tax-exempt employers), which expressly excludes bona fide severance arrangements. In that area, employers have been aggressive in characterizing arrangements as bona fide severance arrangements in an effort to fall outside of the Code section 457(f) rules.

G. Discounted Stock Options

The new rules apparently apply to nonqualified stock options if they have an exercise price that is less than the fair market value of the stock as of the date of grant (i.e., discounted stock options). Government officials have indicated that they are considering addressing the extent, if any, to which a discount may be acceptable. For example, if there is a technical discount because of the averaging methodology followed to establish the exercise price (e.g., price averaged over the five days immediately preceding date of grant), or an inadvertent discount by a non-publicly traded company because valuations are only done annually, the government may provide some relief. In addition, government officials are considering (but have not yet decided) whether there is a range of discounts that may be acceptable.

H. Tandem Plans

The initial guidance is also expected to address how the distribution timing rules apply to "tandem" or "mirror" plans in which the distribution elections under the nonqualified plan follow the distribution elections under the related qualified plan. Government representatives have indicated that plan sponsors will probably have to obtain separate elections under the nonqualified plan and that such elections will probably have to be made at some point in advance of the payment date. In addition, the initial guidance is expected to provide a transition period during which plan sponsors will be allowed to obtain distribution elections for existing arrangements and be deemed to comply with the new requirements (whatever they may be).

I. Initial Deferrals for New Plans/New Participants

Under the new rules, a deferral election must generally be made before the beginning of the year in which the services are performed. There are statutory exceptions for new plans/new participants and performance-based compensation. The initial guidance is expected to address both exceptions. With respect to the new plan/new participant exception, which allows for a deferral election within 30 days of initial eligibility (as to compensation for services performed after the date of the election), the government representatives have indicated that it will be applied narrowly. For example, if a new plan is established and it is essentially a continuation of a prior plan, the exception will not apply. Similarly, if an employee was previously a participant in another deferred compensation arrangement maintained by the employer, the employee may not be able to rely on the exception for a new plan established by the employer, even if the new plan is not a continuation of, or related in any way to, the old plan.

J. Aggregation of Plans

The legislative history to the new rules authorizes the Internal Revenue Service and the Treasury to adopt aggregation rules necessary to implement the new requirements. The government representatives have indicated that they may exercise this authority to adopt rules requiring all deferred compensation arrangements for each employee (or service provider) to be aggregated and treated as a separate aggregated "plan" for each employee. Under this approach, if one of the aggregated arrangements fails to satisfy the new requirements, all of the aggregated arrangements would be treated as failing to satisfy the new requirements and, therefore, subject to the adverse tax consequences. This concept has generated a lot of negative reaction from the public and does not appear to be supported by the statute or legislative history.

K. New Funding Rules

The initial Treasury/IRS guidance is not expected to address the new funding rules (i.e., offshore trusts and funding triggered by changes in the financial condition of the employer). Based on the feedback that the government is receiving from the public to date, government officials are of the impression that the funding issues are not as important as other issues that need to be addressed (including most of those discussed in this Bulletin).

One issue of potential significance in this area may arise during the upcoming lame-duck session of Congress (which is scheduled to begin on November 15, 2004). Efforts may be made (possibly as part of "technical corrections" legislation that may be introduced) to statutorily apply the funding restrictions under the new rules to amounts deferred before January 1, 2005. This would mean that offshore Rabbi trusts would not be grandfathered and would be taxed on January 1, 2005.

III. *Future Developments*

The above discussion addresses the key issues that we have discussed with representatives of the Internal Revenue Service and Treasury to date. This Bulletin is based on informal discussions and represents government thinking only as of the time of the discussion. That thinking could, of course, change in many respects before guidance is issued -- an event which is expected on or before December 21, 2004. In addition, the government has not decided on the nature or timing of any subsequent guidance after the first set.

We will do our best to keep you up-to-date on the rapidly developing government thinking with respect to these dramatic new deferred compensation rules.

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