

## Deferred Compensation: Initial Guidance on the New Tax Law

On December 20, 2004, the Treasury Department issued its first volley of guidance on the new tax law covering non-qualified deferred compensation arrangements. Please read our prior Cooley Alert on new [Section 409A of the Internal Revenue Code](#), which was enacted on October 22, 2004, as part of the American Jobs Creation Act.

Notice 2005-1 is the first of several expected rounds of guidance from Treasury on Section 409A and its treatment of non-qualified deferred compensation. While Notice 2005-1 does not address all of the critical issues, it does provide preliminary guidance on some of the key questions.

### What constitutes a deferral of compensation?

An arrangement results in the deferral of compensation under the new rules if a service provider has a legally binding right to compensation in one taxable year, and the arrangement provides for the deferral of the taxable income associated with that compensation into a future taxable year. Compensation is generally not covered if the service recipient can choose to reduce or not to pay the compensation after the services have been performed. Thus, a discretionary bonus arrangement under which the company can choose not to pay the bonus generally would not be considered deferred compensation. An arrangement under which part of the bonus becomes fixed, but part is discretionary, would generally be covered as to any portion of the fixed amount that is deferred to a later tax year. However, short-term deferrals for less

than 2½ months after the end of a tax year generally will not constitute deferred compensation for purposes of the new rules. It would appear that the deferral of taxable income merely as a result of a substantial risk of forfeiture (*i.e.*, vesting) does not result in a deferral of compensation.

### What are the consequences if an arrangement is treated as a deferred compensation arrangement?

A deferred compensation arrangement will result in taxation, penalties and interest immediately upon vesting, unless the arrangement satisfies certain requirements set forth in Section 409A (see below). If a deferred compensation arrangement does satisfy these requirements, the deferral amount will not be subject to taxation under Section 409A until payout, and no penalties or interest will be imposed.

### What requirements does Section 409A impose to avoid current taxation of deferred compensation?

As discussed in more detail in our prior Alert, Section 409A requires that a deferred compensation arrangement meet the following key requirements in order to avoid current taxation:

► If the deferral of compensation is elective, the service provider must make such election before the beginning of the taxable year in which the services corresponding to such compensation are performed (with an exception for certain performance-based compensation). Sub-

sequent deferral elections to change the timing or form of distribution must meet additional timing requirements.

- The payment of the deferred compensation must not occur prior to: (i) separation from service, (ii) disability, (iii) death, (iv) a fixed date (or dates) specified at the time of deferral, (v) a change in control, or (vi) the occurrence of an unforeseeable emergency. Note that no accelerated payments or "haircut" provisions are permitted.
- The plan must not involve an impermissible funding arrangement such as an offshore trust or a trust, the assets of which become available only to pay deferred compensation upon a change in the employer's financial health.

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### If an arrangement is not subject to Section 409A or meets its deferral requirements, is the compensation guaranteed to be nontaxable until payout?

No. Even if an arrangement is exempt from Section 409A, or meets its requirements for deferral, the amount in question may still be taxable prior to payment under general tax principles such as the “constructive receipt” doctrine.

### Do the new rules cover only formal plans?

In general, any plan, method or arrangement for the deferral of compensation is subject to the new rules. Thus, an agreement to defer compensation with a single service provider is covered. Arrangements adopted unilaterally by the service recipient are covered, as are arrangements negotiated between the service recipient and provider. The arrangement need not be in writing to be covered.

Qualified retirement plans, vacation leave, sick leave, disability and death benefit plans, medical insurance plans, and similar arrangements are not subject to the new rules. In addition, certain severance plans are not required to meet the Section 409A requirements during the 2005 calendar year. However, severance plans that are not amended to meet the Section 409A requirements on or before December 31, 2005, may result in taxation prior to payout for participants, beginning in 2006.

### Is equity-based compensation subject to the new rules?

Equity-based compensation arrangements that result in a deferral of compensation may be subject to the new rules.

- ▶ **Stock Grants/Purchases.** The grant or sale of stock to a service provider will not, by itself, constitute a deferred compensation arrangement, even if the stock is subject to vesting.
- ▶ **Stock Options.** Options qualifying as “incentive stock options” under Section 422 of the Internal Revenue Code, and

non-qualified stock options with an exercise price that must, at all times, equal or exceed the fair market value of the underlying stock on the date of grant, are not subject to the new rules.

Stock options with an exercise price that is or may be less than the fair market value of the underlying stock on the date of grant are considered deferred compensation. Notice 2005-1 indicates that the fair market value of stock for this purpose is to be determined under any reasonable valuation method.

Notice 2005-1 also indicates that Treasury is likely to treat as a deferred compensation arrangement any stock option that is coupled with a “put right” under which the service recipient can require the company to buy back the underlying stock. Similarly, all stock options issued in tandem with other rights (such as a stock appreciation right) are likely to be treated as deferred compensation arrangements.

- ▶ **Stock Appreciation Rights.** A “stock appreciation right” (SAR) is considered deferred compensation, unless it meets the following requirements:
  - ▶ The SAR can be settled only in stock of the service recipient;
  - ▶ The stock underlying the SAR is publicly traded on an established securities market;
  - ▶ The service provider cannot elect upon exercise of the SAR to defer payout of the stock to a later date; and
  - ▶ The SAR pays only the excess in the value of the underlying stock on the exercise date over the value of such stock on the grant date.
- ▶ **Restricted Stock Units.** A “restricted stock unit” (RSU) is not considered deferred compensation if the stock must be issued shortly after vesting occurs. However, if the service provider has the right to elect to defer payout of the stock to a future taxable year, this will be considered a deferred compensation arrangement.

- ▶ **Employee Stock Purchase Plans.** Employee stock purchase plans (ESPPs) qualifying under Section 423 of the Internal Revenue Code are not treated as deferred compensation arrangements.

### Is compensation deferred by consultants covered?

Compensation payable to both employees and consultants is generally covered, with some exceptions for consulting entities using the accrual method of accounting and other consultants who provide substantial services to more than one company. (Director services do not qualify for this purpose.)

### How do the new rules affect non-qualified arrangements linked to qualified plans?

Some employers allow employees to shift “excess” qualified retirement plan deferrals into a non-qualified plan. Other arrangements allow non-qualified plan deferrals to be shifted into a qualified retirement plan at the end of a tax year if the employee has not contributed the maximum amount into the qualified plan. Treasury has informally indicated that such arrangements likely do not satisfy Section 409A, and will therefore result in current taxation of the amount credited to the non-qualified plan. Employers with such “linked” arrangements should consider eliminating such arrangements in 2005.

Note that transition relief is provided for certain existing “linked” arrangements. Employers should consult with counsel concerning which arrangements are eligible for transition relief and the need to amend such arrangements in 2005.

### How are deferral amounts calculated?

Notice 2005-1 does not provide guidance as to how the deferral amount is to be calculated for purposes of determining the tax liability. In some cases, determining the relevant amount may be straightforward, as in the deferral of cash salary. In other cases, such as the vesting of a discounted stock option, it is unclear as to how the taxable

amount would be calculated. Treasury plans to provide further guidance on this question in 2005. Stay tuned for another Cooley Alert on this topic.

### Are there any special reporting requirements for deferred compensation?

Yes. Beginning with amounts deferred in the 2005 tax year, all amounts treated as deferred compensation, whether or not immediately taxable under Section 409A, must be reported on Form W-2 (for employees) or Form 1099-MISC (for consultants).

### Are there any special withholding requirements for deferred compensation?

Yes. Deferred compensation of employees is considered "wages" subject to income tax withholding in the taxable year in which it is subject to tax under Section 409A. This includes amounts deferred in 2004 under a non-grandfathered arrangement that does not satisfy the various requirements of Section 409A. Stay tuned for a future Cooley Alert on this subject.

### When must employment taxes be paid on deferred compensation?

Section 409A does not change the current rules relating to the payment of employment taxes (*i.e.*, "FICA" taxes). Employment taxes generally must be paid with respect to deferred compensation at the time such compensation is deferred or is no longer subject to a "substantial risk of forfeiture" (*i.e.*, when the amount becomes vested). This is true even if the deferred amount is not subject to income tax under Section 409A until a later tax year.

### Are existing deferred compensation arrangements subject to the new rules?

The new rules apply to all amounts deferred after December 31, 2004, and to amounts deferred on or before that date if the deferral arrangement was implemented or materially modified after October 3, 2004. Deferred compensation arrangements in

existence as of October 3, 2004, are generally "grandfathered" and not subject to Section 409A. **However**, if such an arrangement is materially modified after October 3, 2004, it will become subject to the new rules. A material modification is a change to the arrangement that confers a new benefit or right upon the service provider. Note that amounts deferred under a grandfathered plan must still meet the more vague standards of existing law in order to avoid current taxation. Note also that amounts deferred under a grandfathered plan after December 31, 2004, are still subject to the new rules.

New grants or deferrals under a pre-October 3, 2004, plan are **not** grandfathered, unless the parties can prove that the new grant was consistent with the company's historical compensation practices. For example, a vested discounted stock option granted on October 4, 2004, is apparently subject to Section 409A, even if granted under a pre-October 3, 2004, plan, unless the grant was consistent with the company's historic practice of granting similar stock options each October for a significant number of years.

### If an existing deferred compensation arrangement is not grandfathered, is there an opportunity to "fix" it so that it complies with the requirements of Section 409A?

Yes. In order to "fix" an existing arrangement, the parties must **both** (i) operate the arrangement in accordance with the new rules and (ii) amend the plan documents to eliminate impermissible plan terms. Notice 2005-1 allows taxpayers to amend existing deferred compensation arrangements before December 31, 2005, to comply with the deferral requirements of Section 409A. The Notice allows the parties to make this type of amendment without any immediate tax consequences.

*Example:* Employer's deferred compensation plan currently meets all the requirements of Section 409A, except that it allows employees to elect to receive a payout

before the scheduled distribution date in exchange for a "haircut" or reduction in the amount of benefits. Thus, in its current form, the plan will not meet the deferral requirements of Section 409A. An employee wishes to defer an additional amount under this plan in 2005. If the plan is amended any time before December 31, 2005, to eliminate the right to accelerate the payout, the employee's additional deferral in 2005 will satisfy the new rules and the deferred amount will not be subject to tax under Section 409A until payout.

### Should employers be aware of any other key dates?

Yes. Employers should be aware of the following key dates during and after 2005:

- ▶ **Last Day to Defer Under a Grandfathered Arrangement: December 31, 2004.** As noted above, amounts deferred before December 31, 2004, under a grandfathered arrangement, may not be subject to Section 409A if the parties can prove that such deferrals are consistent with the company's historic compensation practices. However, because there is a presumption that new deferrals are not grandfathered, employers should exercise great caution in permitting new (pre-12/31/04) deferrals under grandfathered arrangements, unless they plan to amend the arrangement to comply with Section 409A.
- ▶ **2005 Deferral Elections by March 15, 2005.** If any arrangement allows a service provider to elect to defer compensation, Section 409A generally requires that election to be made before the beginning of the taxable year in which the services corresponding to such compensation are to be performed. For 2005 deferrals, Notice 2005-1 allows such elections to be made as late as March 15, 2005.
- ▶ **2005 Performance-Based Compensation Elections by June 30, 2005.** For deferral arrangements involving so-called "performance-based compensation," Section 409A allows a deferral election to be made at least six months before satisfac-

tion of the performance criteria. For such arrangements on which the performance condition may be met by the end of 2005, the deferral election should be made on or before June 30, 2005. (Note, special timing rules may apply for fiscal year companies.)

► **Plan Amendments by December 31, 2005.**

As noted above, deferred compensation plans and arrangements should be amended on or before December 31, 2005, to comply with the deferral requirements of Section 409A.

► **Plan Terminations by December 31, 2005.**

If the parties decide that the new rules make an existing deferred compensation arrangement unattractive, Notice 2005-1 permits them to terminate the arrangement by paying out any amounts previously deferred and eliminating the right to future deferrals under the arrangement. Such terminations must occur prior to December 31, 2005, in order to avoid penalties and interest. Any payout of previously deferred amounts will be subject to income tax at the time of payout. Note that a plan may be "terminated" with respect to one service provider, but not another.

► **2006 Deferral Elections by December 31, 2005.**

Elections to defer compensation relating to services to be performed in 2006 must be made on or before December 31, 2005. (Note, special timing rules may apply for fiscal year companies.)

► **Reporting for 2005 Deferrals by January 31, 2006.**

Amounts deferred during 2005 must be reported on Form W-2 or 1099-MISC, as applicable, on or before January 31, 2006.

► **Wage Withholding for Noncompliant Arrangements.**

If an employer has no intention of amending a deferred compensation plan in 2005 to meet the Section 409A requirements, then the employer must begin wage withholding with respect to amounts deferred under the plan. Exactly when an employer should withhold with respect to

amounts deferred before January 1, 2005, (which are nonetheless currently taxable under Section 409A unless grandfathered) is not entirely clear. However, it appears that such withholding should occur on December 31, 2004, with the amount of income based on certain calculation guidelines described in the Notice. Again, because noncompliant plans can be amended any time before December 31, 2005, it is expected that most employers will choose to make such amendments and avoid the need to withhold taxes on deferred amounts.

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### Action Items

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- Calendar the dates listed above and communicate the relevant dates to affected employees. Most urgently, communicate the March 31 deadline for 2005 deferral elections.
- Consult with counsel regarding the need to amend existing plans and arrangements (including outstanding stock options and SARs) to comply with Section 409A.
- Confirm that employment taxes are being paid with respect to deferred amounts no later than vesting.