

A light blue background featuring a blurred image of a business meeting. In the foreground on the left, a person in a dark suit is holding a white folder and a mobile phone. In the background, several other people in business attire are walking or standing, creating a sense of a busy office environment.

# **Deferred Compensation Issues: Election Timing, Distribution Events and Severance**

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# Agenda

- New rules under Section 409A
- Notice 2005-1
  - Transition rules
  - Initial guidance
- Severance Issues
- Deferral Elections
- Distributions
- What to do now

## Law in Effect Before January 1, 2005

- Tax rules relating to deferred compensation derived from case law, IRS rulings and limited statutory requirements.
- Elections had to be made in advance of payment date to avoid constructive receipt of income.

## New Code Section 409A: General Rules

- Deferred compensation results in current taxable income as of the date the income is fully earned and not subject to a substantial risk of forfeiture unless 409A requirements are met.
- Section 409A imposes requirements on the timing of deferral elections and distributions.
- Applies to amounts deferred after 12/31/04

## 409A Grandfather

- Amounts deferred before 12/31/04 are not subject to 409A if grandfathered.
  - Record keeping issues
  - Two plan approach
- Material modification of a grandfathered plan after 10/03/04 will destroy grandfather treatment for all participants.
  - Benefit/right/advantageous feature
  - Even if new provision is otherwise 409A compliant-- e.g., hardship provisions

## Failure to Comply

- Compensation deferred under the plan is included in gross income when not subject to a substantial risk of forfeiture.
- In addition to income inclusion, the following apply (to the individual):
  - Penalty tax of 20% of amount included in income and
  - Interest is assessed on the tax underpayments (at underpayment rate plus 1%)

# Deferral Elections

- Must generally be made by the close of the tax year before compensation is earned, with two exceptions
  - Newly eligible participants
    - 30 days of first eligibility for amounts earned after election is made
  - Performance based compensation
    - 6 months before the end of the performance period
    - unclear application for 2006 and later years

# Special 2005 Rule for Performance Based Compensation

- Election by 6/30/05 for calendar year bonus
- 12-month or longer performance period
- Payout of amount contingent on satisfaction of organizational or individual performance criteria
  - Cannot be substantially certain to be met
  - Need not be approved by shareholders or Compensation Committee
  - Subjective performance criteria are permitted but must relate to performance of participant or group or business unit including participant
  - Determination cannot be made by participant or family member

# Timing of Distributions

- Distributions may not be made earlier than:
  - Separation from service
    - 6 months after separation from service for key employees of public companies
  - Disability
  - Death
  - Specified time
  - Change of control -- as defined by IRS
  - Unforeseeable financial emergency -- narrowly defined

# Timing of Distributions

- No acceleration of the time or schedule for making payments is permitted; exceptions:
  - Domestic Relations Orders
  - Conflict of interest
  - Payment of taxes
  - *de minimis* cashouts

## Second Elections

- After 2005, change in time or form of deferral permitted only if the following rules are satisfied:
  - Election not effective for 12 months after it is made
  - Election re: specified time must be made at least 12 months prior to first scheduled payment
  - Delay distribution commencement for at least 5 years (except if death, disability or hardship)

# Key Employee

- Key employee of a public company is:
  - An officer having annual compensation greater than \$135,000 for 2005 (up to 50 employees)
  - Employee who is a 5% owner
  - Employee who is a 1% owner and has annual compensation greater than \$150,000
- Lookback issues
- Controlled group issues
- Foreign publicly traded parent issues

## Notice 2005-1: Transition Rules & Initial Guidance

- Deferral elections for amounts earned prior to 12/31/05 may be made by 3/15/05 (but only as to amounts not currently paid or payable)
- Election need only effect the deferral
- Distribution elections may be changed in 2005
- Prior deferral elections may be modified/cancelled in whole or in part in 2005 if included in income
  - Plan must permit this

## Notice 2005-1 (continued)

- Short-term deferrals will not be considered deferred compensation
  - Plan must provide for payment within 2-1/2 months after year in which benefit vests
- Under 409A, acceleration of vesting is OK; not acceleration of payments

## Notice 2005-1 (continued)

- Plan documents are required to be amended by 12/31/05
- Good faith compliance during 2005
- Take advantage of full 2005 year to figure this out- additional Treasury guidance likely mid-year

# Severance

- Severance that constitutes deferred compensation is generally subject to 409A
- For 2005 only, collectively bargained severance plans and severance plans that cover no key employees are excluded from 409A coverage

# Severance

- What is severance that constitutes deferred compensation?
  - Compensation that is earned in one year and paid in another year.
- Compensation is earned when the employee has a legally binding right to receive it.
- Perhaps a distinction between termination without cause and good reason termination.

# Severance

- Until further guidance, compensation paid during current year or within 2-1/2 months of the close of the year in which earned is not deferred compensation.
  - Election to defer not permitted

# Severance

- What types of severance benefits may be deferred compensation -
  - Cash
  - Taxable health coverage
  - Moving expenses
  - Job search expenses
  - Continued perquisites
  - Additional credit under SERPs
  - What else- airplanes? Office/secretarial support?

# Severance Issues

- How to handle 6 month delay for payments to key employees
  - Major issue: is severance that is triggered currently and paid immediately in a lump sum subject to 6 month wait?
  - Pay all amounts within 2 1/2 months after year of severance
  - Claw back for violation of non-compete OK
  - Extend payments, withhold payments for 6 months
    - security issues?

## Severance Issues (continued)

- Notice 2005-1 provides flexibility for 2005
  - Address 6 month rule through “partial termination” of plan

## What To Do Now

- Evaluate which severance plans and employment agreements provide for deferred compensation
- Divide plans to create separate plans covering:
  - Collectively bargained employees
  - Non-key employees
  - Key employees

## What To Do Now

- Review employment agreements and other arrangements:
  - Determine if amounts will be deferred compensation
  - Consider how to restructure arrangements so as to prevent 409A issues

# Off-Shore Rabbi Trusts

- Original 409A provision-- grandfathering
- Effect of Technical Corrections Bill
- What to do in 2005

# Elections

- Review all arrangements to see whether 3/15 election is advantageous
  - Any period involving 2005 (if not paid or payable)
  - Fiscal year plans
  - Alternative to using the performance based compensation/6 month rule
  - Plan must have been in existence on 12/31/04

## Cancellation or Modification of Election

- Through 12/31/05, plan sponsors may amend plans to allow participants to terminate participation in a plan or cancel a deferral election as to non-grandfathered amounts
  - Resulting amounts must be included in 2005 income
  - Be careful about losing grandfather for otherwise grandfathered amounts

# Distribution Events

- Notice 2005-1 provides little guidance as to how rules work with respect to permissible distribution events
- Follow-up guidance must address

# Distribution Events

- The new rules seem to turn traditional deferred compensation planning on its head:
  - Old course: defer for as long as possible, subject to acceleration events or further election
  - New course: defer for a short period (less than 2 years?), then re-defer for 5 years?

# Distribution Events

- If possible, postpone decisions on plan design until after issuance of further guidance
- Be careful not to take action that will eliminate grandfather status

## Supplemental Plans

- SERPs, non-qualified pension plans or 401(k) plans covered by 409A
- Choices among annuities/lump sums
- Linkage to qualified plan is a major issue
  - For 2005, “linked” distribution elections are permissible; probably not thereafter
  - Permissible distribution events under qualified plan may not work under 409A
  - 6 month rule for key employees
  - Spillover plans may be at risk

# Conclusion

- Three important dates in 2005:
  - 3/15: deferral elections
  - 6/30: “relaxed” performance based plan election for calendar year plans
  - 12/31: plan amendments; modification/revocation
- Wait for further guidance if you can
- Inventory arrangements; get Board approval for amendments
- Follow up webcast re equity compensation and employment agreements