KIRKLAND & ELLIS LLP

Alert

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NEW LAW IMPOSES STRICT DEFERRED COMPENSATION TAX RULES

The "American Jobs Creation Act of 2004" (the "Act"), signed by the President on October 22, 2004, imposes strict new tax rules on nonqualified deferred compensation. The new rules:

- Apply broadly to all arrangements deferring payment of compensation (apparently including an equity-based arrangement such as a stock option in-the-money when granted, a stock appreciation right, or a restricted stock unit), other than (1) compensation deferred under a qualified pension, profit sharing or similar plan or (2) a bona fide vacation, sick leave, disability or death pay plan.
- Apply to payments to independent contractors (e.g., consultants, directors, etc.) as well as payments to employees.
- Impose strict rules for a service provider's deferral election.
- Impose strict limitations on payment triggers.
- Require current income inclusion if (1) assets funding deferred compensation are set aside offshore or in an offshore trust or (2) the arrangement requires assets to be set aside (or assets are actually set aside) upon a change in the employer's financial condition.
- Impose current income inclusion plus harsh penalties (i.e., a 20 point increase in the tax rate, from 35% to 55%) on deferred compensation not satisfying the strict new requirements.

The new rules are effective for (1) amounts deferred on or after 1/1/05 and (2) amounts deferred before 1/1/05 under an arrangement that is materially modified after 10/3/04 (unless modified in a manner permitted under regulations IRS is directed to issue within 60 days). Additionally, the new rules apparently apply to amounts deferred before 1/1/05 that are subject to a substantial risk of forfeiture (an SRF) -- generally a provision that the service provider forfeits the deferred compensation if he or she ceases to be an employee before a specified date or if specified business goals are not achieved -- that does not lapse until after 2004.

K&E Comment: Amending an existing arrangement before issuance of the transitional regulations risks causing all amounts deferred under the arrangement to be currently included in the service provider's income at a federal tax rate of up to 55% (i.e., a 20% penalty), plus interest, where the existing arrangement does not meet the requirements of the new rules. Since most existing arrangements do not meet the requirements of the new rules, existing arrangements should not be amended after 10/3/04 until regulations are issued.

Many of the complex rules discussed below are vaguely drafted, and application of the rules in numerous cases depends on fine distinctions among similar, but not identical, deferred compensation arrangements. As a consequence, any conclusion for a specific arrangement entails careful review of the arrangement and related facts.

Definition of Deferred Compensation

Based on the legislative history, the new rules apparently adopt the definition of deferred compensation that is based on a presumption contained in a long-standing regulation, i.e., compensation is "deferred" if paid more than 2 ½ months after the end of the taxable period in which the compensation is

earned. However, it is not clear whether compensation earned over a period that spans more than one taxable year, or that is subject to an SRF (herein referred to as "vesting") over a period that spans more than one taxable year, is considered "deferred compensation" and therefore subject to the new rules. Based on the application of general principles and informal comments by Treasury officials, the remainder of this alert assumes that compensation is generally not "deferred" if paid within 2 ½ months after it has been earned or has vested.[1] However, it is possible that future regulations may take a different position on this question.

K&E Comment: The new statute uses the term "taxable year" without stating whether this refers to the employer's taxable year or the service provider's taxable year, which generally differ where the employer uses a non-calendar tax year. The legislative history states that regulations are expected to address this issue. We expect those regulations to say that the employer's taxable year generally governs, because compensation is usually established for periods that correspond to the employer's accounting period.

Deferral Requirements under the New Rules

To avoid current income inclusion and penalties under the new rules, an arrangement deferring compensation must (1) satisfy specified timing requirements for making and amending a service provider deferral election, (2) permit payment of the amount deferred only upon the occurrence of one of 6 permissible payment triggers, and (3) not permit accelerated payment of the deferred amount except under limited circumstances to be identified in regulations. While the first requirement applies only where the service provider has a choice as to deferral, the last two requirements apply whether the service provider has a choice or the employer merely awards deferred compensation to the service provider.

1. Timing requirements for service provider deferral elections. Where the service provider is given the right to defer **non-performance-based compensation** for services performed during a taxable year, the service provider must make the election to defer no later than the close of the preceding taxable year. An exception permits a service provider to elect to defer compensation within 30 days after first becoming eligible to participate in a deferral plan, but in that event the service provider may defer compensation only for services performed after making the election.

For **performance-based compensation**, a service provider's election to defer may be made no later than 6 months prior to the end of the performance measurement period if (1) the period is at least 12 months long and (2) the amount of compensation is not readily ascertainable at the time of the election. The legislative history states that "performance-based compensation" is intended to have a meaning similar to the meaning given that term in Code §162(m), i.e., compensation that is based on a pre-established, objective formula, the outcome of which is substantially uncertain when established.

A **subsequent election** to further defer payment of previously deferred compensation (whether or not performance-based) must satisfy each of the following requirements:

a. The subsequent election must be made at least 12 months before the first scheduled payment.

b. The subsequent election must defer the first payment with respect to which the election is made at least an additional 5 years (unless the payment is triggered earlier by the service provider's death, disability or unforeseeable emergency).

c. The subsequent election may not be effective for at least 12 months after made.

2. Permissible distribution triggers. The deferral arrangement may not permit payment to be made prior to the earlier of the following:

a. The service provider's separation from service (but no earlier than 6 months following

[1] The legislative history states that the new rules do not apply to annual bonuses or other annual compensation paid within 2 ½ months after year end, but does not address compensation not payable with respect to an annual period.

separation from service in the case of a key employee of a public corporation).

b. The service provider's disability.

c. The service provider's death.

d. A date or fixed schedule established at the time of deferral.

e. To the extent permitted under future regulations, a change in ownership or effective control, or a change in ownership of a substantial portion of the assets of, a corporation.[2]

f. The occurrence of an unforeseeable emergency, defined narrowly as described below.

Payment may not be triggered by the occurrence of an event the timing of which is uncertain, e.g., the date the service provider's first-born child begins college.

K&E Comment. Read literally, the statute appears to permit a deferral arrangement to specify a future payment date and either (1) establish a second, "non-permissible" trigger that also must be satisfied before payment occurs (a "dual-trigger" arrangement) or (2) give the employer discretion to delay payment after the specified date. Under such a literal reading, an arrangement might provide for payment of deferred compensation upon the later of (a) 6/15 of the following year or (b) the date the service provider's first-born child begins college. However, the legislative history strongly suggests that the statute is not intended to permit such an arrangement.

An "unforeseeable emergency" is defined as a "severe financial hardship" resulting from illness, accident, casualty, or similar event. The statute directs IRS to issue regulations limiting the amount that may be distributed under the "unforeseeable emergency" trigger to an amount necessary to satisfy the emergency, plus taxes on the distribution, after taking into account insurance payments and the service provider's ability to liquidate his or her own assets without "severe financial hardship."

3. No acceleration. The arrangement must not permit acceleration of any deferred payment, except under circumstances to be identified in regulations. The statutory language is unclear as to whether an arrangement must (to meet this requirement) explicitly prohibit acceleration or simply not contain any explicit language permitting acceleration.

The legislative history gives two examples of the type of circumstances in which accelerated withdrawals from a deferred compensation account may be permitted: (1) a court-ordered withdrawal (e.g., pursuant to federal conflict of interest rules or a divorce decree) and (2) withdrawals to pay the service provider's share of social security and medicare taxes on the deferred compensation (which taxes are payable when the deferred compensation vests, even if the compensation is deferred for income tax purposes).

Consequences of Failure to Comply with New Deferred Compensation Rules

If a deferral arrangement fails to comply with any of the 3 requirements summarized above, or at any time fails to be operated in accordance with all 3 requirements, then the consequences to each service provider to whom the failure relates are as follows:

- All amounts that have been deferred under the arrangement are required to be included in income currently (or, if later, when vested).
- An additional 20 percentage points of tax is assessed on the total amount required to be included in the service provider's income (resulting in a federal income tax rate of up to 55% at current rates).
- Interest is also assessed, at the underpayment penalty rate plus 1%, on the tax that would have been imposed on the deferred compensation for any earlier taxable years to which the compensation relates had the compensation not been deferred.

[2] This provision in new Code §409A appears to have been copied substantially verbatim from Code §280G, which applies only to compensation paid by a corporation. Regulations may extend this trigger to non-corporate employers. The legislative history also suggests that a more restrictive definition of change in control may be applied for purposes of Code §409A.

"Deferred compensation" includes any investment return (actual or notional) on an amount that has been deferred. Accordingly, where an arrangement fails to satisfy all 3 deferral requirements, all investment return on the deferred compensation is also subject to current income inclusion and penalties as the return is earned.

Deferred compensation that is subject to vesting and fails to satisfy the 3 deferral requirements is subject to income inclusion and the penalties described above when it vests. As discussed previously, while the new rules are not wholly clear, it is likely that a deferred payment subject to vesting that does not meet all 3 requirements is not subject to the penalties imposed under the new rules if it is paid within 2 ½ months after the end of the year in which it vests, on the ground that it is not "deferred compensation" within the meaning of the rules (e.g., a deferred payment right granted in year #1 that fails to satisfy the initial election requirement but is contingent on the service provider remaining employed until the end of year #3 and is actually paid within 2 ½ months after the end of year #3).

Deemed Funding Events

Under the law as it existed before the Act (which continues to apply after the Act), deferred compensation is taxable when "funded" (but not before vesting), and is treated as "funded" when employer assets are set aside to pay such deferred compensation so that such assets are not subject to the claims of the employer's general creditors. However, where the employer sets aside assets to pay deferred compensation but the assets so set aside remain subject to the claims of the employer's general creditors, e.g., a "rabbi trust," such arrangements are not considered "funded," subject to two changes made by the Act.

Under the new deferred compensation rules, either of the following 2 events (each, a "deemed funding event") is also treated as a taxable transfer of property to the service provider:

a. Assets are set aside in a trust (or other arrangement specified by IRS) for purposes of paying deferred compensation, and either the assets are, or the trust is, located outside the United States. However, this rule does not apply if substantially all the services to which the deferred compensation relates were performed in the foreign jurisdiction in which the assets reside.

b. The deferred compensation arrangement requires assets to be set aside and become restricted to the payment of benefits under the arrangement, or assets are actually so restricted, upon a change in the employer's financial condition whether or not the assets are outside the United States.

In either such case, property is treated as transferred even if the assets set aside remain subject to the claims of the employer's general creditors.

The tax consequences to the service provider of a deemed funding event are the same as those that apply to deferred compensation that fails one of the 3 deferral requirements, i.e., current income inclusion (or, if later, inclusion in the year the arrangement vests), tax at regular ordinary income rates plus an additional 20 percentage points (i.e., a maximum federal tax rate of 55%), and interest from the year of deferral (or, if later, the year of vesting) at the underpayment rate plus 1%. In addition, the amount subject to tax and penalties includes all prior periods' investment return (actual or notional) on amounts deferred, and investment return in each subsequent year is also taxed when earned, at a federal tax rate of up to 55%.

Scope of New Deferred Compensation Rules

The new deferred compensation rules apply to (1) compensation deferred by independent contractors as well as employees and (2) compensation paid by noncorporate as well as corporate employers.

However, the new rules do not appear to apply to payments by a partnership (or limited liability company treated as a partnership for tax purposes) to a partner for services rendered to or for the benefit of the partnership when the partner is performing such services in a partner capacity, even where such payments are structured as salary or discretionary bonus payments. Rather, such payments constitute "guaranteed payments" as defined in long-standing Code §707(c) and are subject to special income

inclusion timing rules based on the partnership's method of accounting. Regulations under Code §707(c) state that "guaranteed payments are regarded as a partner's distributive share of ordinary income. … [A] partner who receives guaranteed payments is not regarded as an employee of the partnership for purposes of … deferred compensation plans, etc."

> *K&E Comment. Many private equity funds have adopted "management fee waiver" structures under which the fund's general partner or management agent waives a portion of the management fees to which it is entitled and receives in exchange an interest in future fund profits. The interest in future profits should be treated as an equity interest rather than as compensation and hence should not be affected by Code § 409A. However, if the interest in future profits were successfully recharacterized by IRS as compensation deemed to be received for services not rendered in a partner capacity, the Code § 409A penalties could apply. While we believe such a recharacterization risk is low, it is relevant to a private equity fund principal considering management fee waiver structures.*

Application of New Deferred Compensation Rules to Annual Bonuses

Many employers determine (or if previously determined, reserve the right to adjust) annual bonuses upon completion of their financial statement audits, often more than 2 ½ months following year end. Where an employee is not required to remain employed through the payment date in order to be entitled to such a bonus (i.e., where the payment vests upon completion of the taxable year for which it is payable), the bonus likely constitutes "deferred compensation" if made more than 2 ½ months following year end.

For example, an arrangement under which a bonus for services performed in year #1 is paid 15 days following completion of the year #1 audit does not comply with the distribution trigger limitations of the new deferred compensation rules because completion of the audit is an event the timing of which is uncertain. Thus, the bonus (if paid more than 2 ½ months following year end) would apparently be taxable to the service provider in year #1 at a federal tax rate up to 55%. This unfortunate consequence can be avoided by (a) specifying a fixed bonus payment date (e.g., April 15) when the audit is substantially certain to have been completed, and not accelerating payment if the audit is completed earlier <u>or</u> (b) not vesting the bonus until the scheduled payment date (i.e., the arrangement calls for the service provider to forfeit the bonus if he or she leaves before audit completion). Such adverse consequence likely can also be avoided by actually paying the bonus within 2 ½ months after the end of year #1. In this case, the bonus should not be "deferred compensation" within the meaning of the rules, although there is risk that if the payment was originally expected to be paid on a later date this would be treated under the new rules as an impermissible "acceleration" of deferred compensation, thereby invoking the new penalties.

Application of New Deferred Compensation Rules to Equity-Based Compensation

Non-qualified stock options (NQOs). The legislative history implies that an NQO that is in-the-money on the date granted (i.e., the fair market value of the underlying shares exceeds the NQO exercise price) is nonqualified deferred compensation subject to the new rules. If treated as deferred compensation under the new rules, an NQO in-the-money at grant would therefore apparently be taxable in the year of vesting, based on the NQO's value when it vests, at a federal tax rate of up to 55%. In addition, any increase in the NQO's value in a subsequent taxable year would also be taxable, at a federal tax rate of up to 55%. It is not clear whether the service provider would be entitled to a deduction for a taxable year in which an NQO declines in value, to the extent of the income included by the service provider with respect to the NQO for prior taxable years.

The legislative history states that an NQO that is at-the-money or out-of-the-money at grant (i.e., the exercise price of the NQO is at least equal to the fair market value of the underlying shares at grant) "is not intended" to be subject to the new deferred compensation rules so long as it contains no deferral features other than the discretion to exercise at any time following vesting. However, numerous issues exist with respect to such a "good" NQO:

- A material modification of the "good" NQO after grant, at a time when the NQO is in-the-money, may be treated as the grant of a new "bad" NQO treated as deferred compensation, triggering tax at a federal tax rate of up to 55% on the NQO's spread value in the year of the modification (or vesting, if later) and taxation in subsequent years on a mark-to-market basis.
- The grant of a replacement NQO by an acquiring entity in connection with its acquisition of the original NQO issuer when the NQO is in-the-money may be treated as the grant of a new "bad" NQO treated as deferred compensation, triggering tax at a federal tax rate of up to 55% on the NQO's spread value in the year of the substitution (or vesting, if later) and taxation in subsequent years on a mark-to-market basis.
- In recent years many service providers used the strategy of canceling an NQO shortly before it would have been exercised and substituting a deferred payment right (generally in an amount equal to the spread value of the cancelled NQO). Canceling the NQO when it is in-the-money and substituting a deferred payment right is treated as the creation of a deferred compensation arrangement. Unless carefully structured, such a deferred compensation arrangement likely violates the requirement that deferral must be elected prior to the start of the taxable year in which the compensation is earned, causing the deferred compensation to be subject to current income inclusion, at a federal tax rate of up to 55%. Although not free from doubt, possibilities for structuring the substituted deferred compensation arrangement to comply with the requirements of the new rules include the following:
    1. The substituted deferred payment right is subjected to a performance-based contingency, the remaining performance measurement period is at least 6 months, and the amount of compensation is not readily ascertainable at the time of substitution, <u>or</u>
    2. The substituted deferred payment right is subjected to time vesting (e.g., the payment right is forfeited if the service provider does not remain employed for 12 months following substitution) and the payment right meets all 3 requirements for deferral under the new rules (i.e., timely initial deferral election, payment only upon death, separation from service, specified date). However, there is a substantial risk that IRS would view the period in which the compensation is earned as including the period the service provider held the NQO for which the deferred payment right was substituted, precluding satisfaction of the initial deferral election requirement.
- If the NQO permits net exercise (i.e., the service provider may pay the exercise price by surrendering some of the NQO shares with an aggregate fair market value equal to the aggregate NQO exercise price), and also entitles the holder to receive cash in lieu of shares upon a net exercise, the option may be treated as the functional equivalent of a stock appreciation right (discussed below) and therefore taxable annually on a mark-to-market basis, at a federal tax rate of up to 55%. Moreover, the existence of a net exercise feature may by itself (i.e., even without a cash payment feature) cause such an NQO to be treated as deferred compensation where the NQO shares used to pay the exercise price are never issued (on the basis that such an arrangement is the functional equivalent of a deferred payment in the form of stock).

Incentive stock options (ISOs). The legislative history states that an ISO "meeting the requirements of Code §422" "is not intended" to be subject to the new deferred compensation rules. An option qualifying as an ISO when exercised, but with respect to which there is a subsequent "disqualifying disposition" of the shares received on exercise (i.e., a sale of the shares within 1 year after exercise, or within 2 years after ISO grant), does not satisfy all of the requirements of Code §422 (since the disqualifying disposition violates Code §422(a)(1)'s 1-year, 2-year requirement) and hence is apparently not protected by this legislative history. However, such a disqualified ISO should not be treated

as a deferred compensation arrangement under the exception, discussed above, for options not in-the-money at grant, since an ISO cannot be in-the-money at grant.

Stock appreciation rights (SARs). Traditional SARs are exercisable (after vesting) on a date selected by the service provider and accordingly do not comply with the distribution trigger limitations of the new deferred compensation rules. A traditional SAR granted after 12/31/04 (and apparently an SAR granted before 2005 if not vested at 12/31/04) would therefore be subject to the same harsh tax penalties as an in-the-money NQO (i.e., taxable upon vesting based on the SAR's value at that time, at a federal tax rate of up to 55%, and in each subsequent taxable year on a mark-to-market basis). It is not clear whether the service provider would be entitled to a deduction for a taxable year in which the SAR declines in value, to the extent of the income included by the service provider with respect to the SAR for prior taxable years.

An SAR could be in compliance with the distribution trigger rules so long as the SAR payment dates comply with the permissible distribution triggers (e.g., specified date or dates, death, separation from service), even if the service provider can elect to "freeze" the SAR's value prior to the scheduled payment date. However, it is not clear whether such an arrangement would be as attractive to employers and service providers as are SARs that pay out whenever exercised by the service provider.

Restricted stock units ("RSUs"). RSUs represent the right to receive a specified number of employer shares in the future or, in some cases, to receive a cash payment equal to the value of a specified number of employer shares at the time of payment. To comply with the new rules, an RSU granted after 12/31/04 (and apparently an RSU granted before 2005 if not vested at 12/31/04) must specify the date or dates that payments may be made with respect to the RSU (but it should be permissible for the terms of the RSU to allow the holder to elect to "freeze" the value of the RSU at any particular time prior to the scheduled payment date).

Restricted stock. Restricted stock (i.e., stock issued to a service provider that is nontransferable and subject to an SRF) should not be treated as deferred compensation. Any compensation income resulting from the receipt of restricted stock is subject to tax (1) at the time of vesting if the service provider does not make a Code §83(b) election when the restricted stock is issued or (2) when the restricted stock is issued, if the holder makes a Code §83(b) election. Because such compensation is taxed not later than when vested, it is not "deferred compensation" and any subsequent appreciation in the stock represents an equity return rather than compensation.

In recent years many service providers used the strategy of exchanging restricted stock for a deferred payment right shortly before the restricted stock was scheduled to vest. Such a transaction raises issues and structuring considerations under the new rules similar to those discussed above with respect to canceling an NQO and substituting a deferred payment right (i.e., current income inclusion, taxed at a federal rate of up to 55%, unless the substituted deferred payment arrangement satisfies the 3 deferral requirements).

Implications for Existing Deferral Elections

The new rules do not apply to amounts deferred before 1/1/05,[3] unless deferred under an arrangement materially modified after 10/3/04. The legislative history indicates that an amount is treated as deferred before 1/1/05 only if it is "earned and vested" by 12/31/04. Consequently, certain pre-enactment deferred compensation arrangements may already be subject to, and have failed the requirements of, the new rules. For example, if an annual bonus for 2004 is payable to a service provider only if he or she remains employed through the date the bonus is scheduled to be paid in 2005, and the service provider's bonus deferral election was made after 12/31/03, then the bonus (a) is subject to the new rules and (b) fails to satisfy the requirement that the deferral election be made before the start of the period during which services are performed. The same would be true of an NQO issued

[3] The legislative history suggests that compensation payable by an employer that uses a non-calendar taxable year can be deferred under the old rules prior to the end of the employer's taxable year beginning in 2004 (e.g., until 6/30/05 in the case of an employer with a 6/30 fiscal year). However, because the statute unambiguously states that the new rules apply to amounts deferred on or after 1/1/05, service providers should not rely on the legislative history to reach a different result absent a clarifying IRS announcement.

prior to 1/1/05 that (1) was in-the-money at grant and (2) does not fully vest before 1/1/05.

In order to alleviate this potentially harsh and unfair result, the statute directs IRS to issue regulations within 60 days to permit an existing arrangement to be (1) terminated and all amounts deferred under the arrangement paid out or (2) amended to conform with the new rules, in each case without tainting all pre-10/4/04 deferrals under the arrangement. In the absence of those regulations, it does not appear that the harsh treatment of existing deferral arrangements described above can be avoided by terminating the existing arrangement and paying out the deferred amounts -- even if paid out before 1/1/05 -- since that would be treated as a "material modification" of the arrangement occurring after 10/3/04. (In this regard, the legislative history states that accelerating the vesting of an existing deferred compensation arrangement is treated as a material modification of the arrangement.)

Reporting and Withholding Requirements

Deferred compensation required to be included in income before paid under the new deferred compensation rules must be reported to the IRS and the service provider on IRS Form W-2 or 1099 and is subject to income tax withholding. The current income tax withholding rate for non-periodic payments ("supplemental wage payments") is 25%, but, beginning in 2005, supplemental wage payments in excess of $1 million are subject to income tax withholding at a 35% rate.

Amounts that are properly deferred under the new rules also must be reported on IRS Form W-2 or 1099 for the taxable year the compensation is deferred (even though not included in the service provider's income), presumably in a separate box to be added to those forms.

Employer Deduction

The legislative history states that the new deferred compensation statute "does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation." Under these rules, the employer is normally entitled to claim a compensation deduction on the last day of the service provider's taxable year in which the deferred compensation is taxable. Accordingly, where a service provider's income inclusion for deferred compensation is accelerated because the deferred compensation arrangement fails to satisfy the new rules, or because there is a deemed funding event, the employer's deduction should be correspondingly accelerated.

Should you have any questions about this Alert, please contact any of the following K&E attorneys or the K&E partner or associate with whom you maintain a client relationship:

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