

Nonqualified Deferred Compensation Plans: IRS Issues Transitional Relief

The American Jobs Creation Act ("Act"), signed into law by President Bush on October 22, 2004, significantly changes the federal tax laws affecting nonqualified deferred compensation plans. The Act added a new Section 409A to the Internal Revenue Code ("Code") providing specific rules for deferral elections, distributions and funding mechanisms under nonqualified deferred compensation plans. The Internal Revenue Service ("IRS") issued Notice 2005-1 on December 21, 2004, which is the first guidance from the IRS on the application of Section 409A.

This is our second in a series of newsletters highlighting and discussing Section 409A. Our first e-newsletter, which predated the guidance in Notice 2005-1, provided a summary of the requirements under Section 409A with a suggested course of action. You can find the first e-newsletter, dated October 21, 2004, on the [Reinhart website](#). This newsletter discusses the initial transition rules for complying with Section 409A and recommends actions you should now consider. Future newsletters will discuss in greater detail specific design changes, new reporting and withholding requirements, and additional guidance from the IRS on Section 409A.

Transition Rules for Complying with Section 409A

Section 409A Effective Date: Notice 2005-1 clarifies that Section 409A is effective with respect to (a) compensation deferred after December 31, 2004 and (b) compensation deferred before January 1, 2005 if the plan under which the deferral was made is "materially modified" after October 3, 2004. Section 409A applies to earnings on amounts deferred only to the extent that Section 409A applies to the underlying amounts deferred. Compensation is "deferred" if: (1) the employee has a "legally binding" right to receive compensation, but the compensation is payable in a subsequent year under the terms of the plan, and (2) the right is vested. An amount is not considered vested if the employer has discretion to reduce or eliminate the payment, the amount is subject to a "substantial risk of forfeiture," the amount is conditioned upon the performance of future service by the employee or receipt is conditioned upon the occurrence of certain events, such as achieving company performance goals.

Eligibility for Grandfather Treatment: Compensation deferred before January

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1, 2005, and earnings on that amount, may be "grandfathered" and, therefore, not subject to Section 409A, if the employer does not materially modify the plan after October 3, 2004. The amount that is grandfathered is determined differently for an account balance plan, a defined benefit plan (e.g., supplemental executive retirement plan ("SERP")) or an equity based plan (e.g., stock options and phantom stock). Calculation of the grandfathered amount is critical to preserving that amount as exempt from Section 409A.

Material Modification: A plan is "materially modified" if a benefit or right existing as of October 3, 2004 is enhanced (e.g., vesting is accelerated to a date on or before December 31, 2004) or a new benefit or right is added. A modification may be made by either an amendment to the plan or the employer's exercise of discretion under the terms of the plan. This presumption may be rebutted by demonstrating that the newer enhanced benefit is consistent with historical compensation practices.

An amendment that merely brings a plan into compliance with Section 409A will not be treated as a material modification if it does not add or enhance an existing benefit with respect to grandfathered amounts. An amendment to eliminate or reduce an existing benefit (e.g., the removal of the right to withdraw with a penalty, a "hair cut" provision) or to stop future deferrals is not a material modification. Further, terminating the arrangement and distributing the deferred compensation in 2005 will not be a "material modification."

Amendment Deadline and 2005 Operation: Plan sponsors have until December 31, 2005 to amend any plan to comply with Section 409A. During 2005, employers must operate plans subject to Section 409A in "good faith" compliance with a reasonable interpretation of Section 409A.

2005 Deferral Elections/Revocations and Plan Terminations: Under Section 409A, deferral elections must be made before the tax year in which the services relating to the compensation are performed. However, if a plan was in existence before January 1, 2005, participants may be allowed to defer compensation under the plan provided (a) the deferral election is made by March 15, 2005, (b) the election applies only to compensation that has not been paid at the time of the election, (c) the plan is operated in "good faith" compliance with Section 409A after December 31, 2004 and (d) the plan is amended accordingly by December 31, 2005. In addition, during all of 2005, a plan may grant one or more participants the right to change or revoke an existing deferral election or terminate participation in the plan if (a) the plan is amended to allow for the



revocation or termination by December 31, 2005, and (b) amounts subject to the termination or revocation are included in the participant's taxable income in the year of termination. Termination of a plan by December 31, 2005 will not subject the deferred compensation, which is includable in participants' taxable income, to the 20% penalty of Section 409A.

Transition Rule for Payment Elections: Participants may make new elections as to the timing or form of payment applicable to amounts deferred prior to the election, provided the participant makes the election and the plan is appropriately amended by December 31, 2005. An outstanding stock option or stock appreciation right also may be amended to provide for fixed payment terms in accordance with Section 409A if the amendment is made before December 31, 2005.

Transition Rule for Severance Plans: A severance pay plan is not required to comply with Section 409A until January 1, 2006 if the plan either is collectively bargained or does not cover any key employees. If an employee does not have a legally binding right to severance benefits before the benefits are awarded and benefits are paid in a lump sum, the benefits may be exempt from Section 409A under the exception for short-term deferrals.

Reporting and Withholding: Section 409A imposes new withholding and reporting requirements on plan sponsors. The reporting and withholding requirements apply to amounts actually deferred in 2005, but the general reporting of deferred compensation in box 11 of form W-2 still applies for amounts deferred in 2004. Amounts that are subject to taxation under Code section 409A in 2005, and are not actually or constructively received by the employee, may be reported on an employment tax return in any quarter in 2005. The employer may withhold tax on such amounts on any date before January 1, 2006.

Performance-Based Compensation Elections: An election to defer performance-based "bonus compensation" may be made as late as six months before the end of the performance period on which the bonus is based. Notice 2005-1 states that the term "bonus compensation" refers to compensation that is (a) based on service performed over a period of at least 12 months, (b) contingent on the satisfaction of organizational or individual performance criteria and (c) based on performance criteria not substantially certain to be met at the time a deferral election is permitted. Bonus compensation may also include payments based on subjective criteria if certain conditions are satisfied and the

determination of meeting such criteria is not made by the employee or a family member of the employee. The payments may be based on performance criteria not approved by a compensation committee of the board of directors or by the stockholders or members of the employer.

Bonus compensation does not include any amounts that will be paid regardless of performance, based on a level of performance that is substantially certain to be met at the time the criteria is established, or based solely on the value of, or appreciation in value of, the employer or its stock. A plan sponsor that is uncertain about a bonus meeting the standards for bonus compensation should consider having employees make deferral elections by March 15, 2005. The IRS anticipates that future guidance will be more restrictive in defining bonus compensation.

Action Plan: What You Should Be Doing Now

1. **Identify All Nonqualified Deferred Compensation Plans:** Notice 2005-1 provides that nonqualified deferred compensation plans are any plans that provide for a deferral of compensation. A plan provides for a deferral of compensation if it provides that an individual has a legally binding right to compensation that is not actually or constructively received and included in gross income, and the compensation is payable to or on behalf of the individual in a later year. The application of Section 409A is not limited to plans between an employer and an employee, but may include arrangements between a service recipient and an independent contractor, or a partner and a partnership.

Plans that are subject to Section 409A and Notice 2005-1 include, but are not limited to:

- Elective salary deferral arrangements (e.g., top-hat plans, deferred compensation plans);
- Mirror/401(k) "wrap" plans;
- Excess benefit plans;
- Elective annual and long-term bonus deferral arrangements (unless paid within 2-1/2 months after the close of the calendar year in which service was performed or the close of the employer's fiscal year in which the right to the compensation is no longer subject to a substantial risk of forfeiture);
- Code section 457(f) arrangements;
- Stock options, Stock Appreciation Rights ("SARs") and equity-based compensation (with certain exceptions);

- Phantom stock, restricted stock units, performance units and change in control plans to the extent they provide a deferral of compensation;
- SERPs;
- Individual employment contracts or severance arrangements with a deferral feature; and
- Any other arrangement that includes a deferral of income feature.

Section 409A does not apply to employee stock purchase plans under Code section 423, incentive stock options subject to Code section 422 or nonqualified stock options with an exercise price of at least fair market value on the date of grant and no "exercise gain" deferral feature. Nonqualified deferred compensation plans do not include restricted property (in most cases); tax-qualified plans; bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans; eligible deferred compensation plans within the meaning of Code section 457(b); Code section 415(m) excess benefit arrangements for governmental entities; or Archer Medical Savings Accounts, Health Savings Accounts or any other medical reimbursement arrangements.

2. Review Deferral Elections and Bonus Elections for 2005: Plan sponsors may permit participants to elect to defer compensation relating to services to be performed in 2005 if (a) the plan was in existence prior to January 1, 2005, (b) the compensation to be deferred has not been paid or become payable at the time of the election and (c) the election is made by March 15, 2005. An election to defer bonus compensation based on services performed over at least 12 months, however, may be made as late as six months before the end of the performance period. For bonus compensation based on the 2005 calendar year, an election to defer all or any portion of the bonus must be made by June 30, 2005.

3. Identify Amendments to Nonqualified Deferred Compensation Plans Intended to Become Subject to Section 409A: While plans do not need to be amended until December 31, 2005, plan sponsors must operate the plans in good faith compliance after December 31, 2004, consistent with the Act and Notice 2005-1. Amendments may be clearly required by Section 409A or may be required depending upon future IRS guidance. The IRS has advised that it will provide additional guidance in June 2005. Plan sponsors may want to wait to make actual plan changes until after this additional guidance is issued. Many plans will need significant revisions, particularly to distribution and deferral election options. Waiting will help avoid going back to the board of directors or compensation committee (or possibly the executive) for amendment approval. Strategies for uncertainty may include a board delegation of authority to amend or draft plan



provisions for interpretation consistent with subsequent IRS guidance.

4. Determine an Appropriate Strategy in Response to Section 409A and

Notice 2005-1: Once plan sponsors have identified Section 409A's overall impact on their plans, plan sponsors will want to determine the best compliance strategy, including a strategy of when and how to inform participants of the potential impact of Section 409A on them. Plan sponsors may amend existing plans to comply with Section 409A, or grandfather existing plans and establish new plans for post-2004 deferrals. Plan sponsors can also consider freezing plans if elections are cancelled prior to March 15, 2005. Or, a plan sponsor may terminate a plan and distribute the deferred amounts in 2005. Plans with both grandfathered deferred compensation and deferred compensation which is not grandfathered might be modified to comply with Section 409A with respect to the "new money" only, with the "old money" continuing under the existing plan. This approach, however, is particularly tricky since the plan may not be "materially modified." Amending a plan to comply with Section 409A is not a "material modification," but a plan sponsor must be careful not to add a new benefit, or enhance an existing benefit, in the process.

The new rules are complicated and plan sponsors should carefully review their nonqualified deferred compensation plans. In addition to our newsletters, compliance checklists are available upon request. In addition, a chart discussing Section 409A and Notice 2005-1 in detail is available on the [Reinhart website](#).

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