Deferred Compensation: Devising a Game Plan for Compliance with Section 409A

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The new rules are burdensome, but employers can take specific, systematic steps to ensure compliance.

On October 22, 2004, new Section 409A of the Internal Revenue Code of 1986 was signed into law as part of the American Jobs Creation Act of 2004, P.L. 108-357 Section 409A represents a sea change in the federal tax treatment of deferred compensation, and employers will now be faced with a dizzying array of restrictions on deferral elections, distributions to plan participants and funding arrangements. The consequences of failing to comply with the new rules in Section 409A will be severe: Plan participants not only will be required to include deferrals in taxable income for federal income tax purposes before the deferrals are paid but also will be required to pay an interest charge and a 20% penalty tax on the deferrals

The Treasury Department and Internal Revenue Service (IRS) published the first set of transitional guidance on Section 409A, Notice 2005-1, on December 20, 2004, and further guidance is forthcoming. The guidance issued in December focused mainly on identifying covered deferred compensation arrangements and setting out rules relating to the effective date and transition rules. The next set of guidance is likely to address issues relating to distributions and deferral elections.

Deferred compensation plans must be amended to achieve compliance with the new rules by December 31, 2005, but it will be difficult for employers to draft new plans that would comply with Section 409A until more detailed guid-

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EXHIBIT 1

Steps to Take in 2005 to Achieve Compliance with Section 409A

Inventory plans and identify possible deferred compensation arrangements

Identify grandfathered arrangements and avoid material modifications of such plans

Comply operationally with Section 409A in good faith

Determine whether initial deferral elections under existing plans were obtained by March 15, 2005

Obtain initial deferral elections under calendar year 2005 bonus plans by June 30, 2005

Amend plan to conform to Section 409A by December 31, 2005

Obtain participant distribution elections by December 31, 2005

Terminate or cancel participant deferral elections for amounts deferred after 2004, if desired, by December 31, 2005

Terminate and pay out pre-2005 grandfathered deferrals, if desired, by December 31, 2005

Coordinate with payroll regarding reporting of distributed amounts as well as reporting of deferrals for 2005

ance, particularly regarding elections and distributions, is released There are, however, important steps that employers should take in the meantime to take advantage of certain transitional relief provided by the IRS and to ensure favorable treatment for their existing plans. An outline of important steps to be taken in 2005 is provided in Exhibit 1.

Section 409A Basics

Section 409A applies broadly to deferred compensation arrangements, which include elective salary deferral arrangements, elective annual and long-term bonus deferral arrangements, supplemental retirement plans, excess benefit plans and mirror 401(k) plans, severance arrangements, discounted stock options and discounted stock appreciation rights, Section 457(f) plans and deferred compensation or incentive plans for directors, sales representatives and independent contractors.

As employers devise a game plan for bringing their deferred compensation plans into compliance with Section 409A, they should keep in mind the potentially expansive plan amendments that Section 409A will require. Section 409A imposes new restrictions on a variety of features of such deferred compensation arrangements As noted above, although the recently released Treasury Department and IRS guidance deals principally with coverage and effective date issues, including transition rules and the maintenance of grandfather protection for existing plans, the anticipated future guidance will likely require significant changes to plan provisions addressing initial and subsequent elections, acceleration of payments, distributions and possibly funding arrangements.

For example, second or subsequent elections with respect to payout of deferred compensation generally will be limited such that they may not take effect for at least 12 months and, where the election is made with respect to a fixed payment date, must be made at least 12 months prior to the originally scheduled payout date. In addition, payments that are the subject of such elections must be deferred for at least five additional years. Acceleration of payments will be generally prohibited except in very limited circumstances. Distribution events must be hard-wired into plans—it generally will no longer be permissible for employers to retain discretion whether to pay or not to pay—and must be limited to separation from service (with a six-month delay in payments for certain key employees), disability, death, a specified date, a change in control of the corporation or an unforeseeable financial emergency.

Steps to Take Now

The new rules require significant changes, but employers can begin to pull their plans into compliance by taking the following steps:

1. Make sure that you have identified possible deferred compensation arrangements.

To the extent employers have not already done so, they should identify in light of the December guidance deferred compensation arrangements that may be affected by Section 409A. The scope of what constitutes "deferred compensation" is quite broad, and the new rules will apply not only to what one might consider plans or programs

EXHIBIT 2

Types of Deferred Compensation Arrangements Covered/Not Covered by Section 409A

Covered	Not Covered
Elective salary deferral arrangements	Short-term deferrals of annual compensation or bonuses (i.e., payment no later than 2½ months beyond taxable year of employer or employee)
Elective annual and long-term bonus deferral arrangements	Incentive stock options and options granted under employee stock purchase plans qualified under section 423
SERPs, excess benefit plans and mirror 401(k) plans	Other undiscounted stock options with no additional deferral features
Severance arrangements	Undiscounted SARs that are settled in stock traded on an established securities market and have no additional deferral features
Individual executive contracts with salary continuation or post-retirement taxable fringe benefits	Restricted stock
Discounted stock options	
Stock options with additional deferral features	
Discounted and cash-settled (SARs)	
Phantom stock and restricted stock units	
Section 457(f) plans	
Deferred compensation for directors, sales representatives and independent contractors	

Note: SERP = supplemental retirement plan; SARs = stock appreciation rights

but also to such things as individual executive contracts that provide for salary continuation and even potentially postretirement taxable fringe benefits. The new rules do, however, provide for certain exceptions. For example, for now, short-term deferrals, that is, plans or arrangements that require payment within two and a half months from the end of the employer or the employee's taxable year in which the employee's right to the payment vests, do not constitute deferred compensation to which Section 409A applies. Some equity arrangements are also specifically excepted from the new rules. Deferred compensation does not include incentive stock options, options granted under Section 423 employee stock purchase plans, and undiscounted stock options (i.e., options where the strike price is at least equal to the stock's fair market value at the date of grant) without additional deferral or cash-out features. Stock appreciation rights (SARs) are excluded but, except for certain grandfathered arrangements, only if (a) they are undiscounted, (b) the stock is traded on an established securities market, (c) they may only be settled in such traded stock and (d) there are no additional deferral features. See Exhibit 2 for examples of what arrangements are covered and not covered under Section 409A.

2. Identify grandfathered arrangements.

Employers should identify amounts deferred prior to January 1, 2005, that are eligible to benefit from the grandfather provisions of the new rules, which generally exempt such amounts from the new requirements of Section 409A. Amounts are considered deferred and eligible for grandfather treatment if, as of December 31, 2004, (a) the employee has a legally binding right to be paid the amount and (b) the amount is earned and vested. For this purpose, amounts are considered earned and vested if the amount is not subject to a substantial risk of forfeiture or a requirement to perform further services. There is a special rule for SARs that are granted under a plan in existence on October 3, 2004, which will treat them as exempt from Section 409A if they are undiscounted and have no additional deferral features.

3. Undertake good faith compliance with Section 409A and preserve grandfathered plans

Effective immediately, employers must operate their deferred compensation plans or the portion subject to Section 409A in good faith compliance with Section 409A and Notice 2005-1. Employers need not amend their plans to comply with Section 409A until December 31, 2005, and

probably will not be able to draft new compliant plans until further guidance is published, but they must operate their plans in good faith compliance in the meantime Employers should review their existing plans (or the portion subject to Section 409A) to determine whether they are operating in good faith compliance with the provisions of Section 409A and Notice 2005-1 For example, employers may not retain and exercise discretion to delay or extend payments under a deferred compensation plan As they strive to achieve good faith compliance, plan administrators will want to be aware of Section 409A's restrictions on accelerations and distributions, such as the requirement that distributions on the separation from service of certain key employees of public companies must be delayed until at least six months after the separation date

Employers should also keep in mind the potentially retroactive effect of Section 409A. Amounts deferred prior to January 1, 2005, under existing deferred compensation arrangements are entitled to grandfather relief and are not subject to Section 409A so long as there has been no "material modification" of the plan after October 3, 2004 A material modification is defined as the enhancement of a benefit or right existing as of October 3, 2004, or the addition of a new benefit or right. For example, the addition of a 10% "haircut" provision by which participants could accelerate distributions would be such a material modification Employers should take pains to ensure that they do not materially modify grandfathered plans, and they should be aware that amounts deferred under existing plans that have lost their grandfather relief because of a material modification are fully subject to the restrictions of Section 409A.

4 Determine whether initial deferral elections under existing plans were obtained by March 15, 2005

Notice 2005-1 permitted employers to obtain initial deferral elections under existing plans that are subject to the new rules as late as March 15, 2005 For plans that were in existence on or before December 31, 2004, the new rules' restrictions on the timing of deferral elections will not apply to any elections made on or before March 15, 2005, so long as the elections relate to amounts that have not yet been paid and have not yet become payable If participants wanted to increase deferral elections made prior to March 15, 2005, employers could have obtained an increased initial deferral election until this date even if the prior election complied with Section 409A Employers that did not secure initial deferral elections by March 15 will need to consider whether the initial deferral elections may still be made under the regular initial deferral election rules or the rule for performance-based compensation exception. If a deferral falls within the performance-based compensation exception, as described below, elections may be made up to six months prior to the end of the service period It is rumored that the Treasury Department and the IRS are considering some further relief from the March 15 deadline for certain plans, for example, 401(k) mirror plans, but no assurances can be given that further relief will be forthcoming.

Employers should take pains to ensure that they do not materially modify grandfathered plans, and they should be aware that amounts deferred under existing plans that have lost their grandfather relief because of a material modification are fully subject to the restrictions of Section 409A.

5 Obtain initial deferral elections under calendar year bonus plans.

By June 30, 2005, employers must obtain initial elections for deferrals under bonus plans with a 12-month service period ending December 31, 2005. Although Section 409A generally requires that initial deferral elections be made before the tax year in which an employee performs services

that give rise to the compensation, it provides for an exception for "performance-based compensation." In the case of performance-based compensation, the initial deferral election must be made at least six months prior to the end of the performance period. Until additional guidance is issued, Notice 2005-1 provides special transition relief that defines the category of bonus compensation to which this six-month rule applies. For purposes of this transition relief, bonus compensation refers to compensation (a) that is contingent on the satisfaction of organizational or individual performance criteria and (b) for which the performance criteria are not substantially certain to be met at the time that a deferral election is permitted. The Treasury Department and the IRS have warned employers that future guidance is likely to adopt a more restrictive definition of performance-based compensation

End of Transition Period

Before December 31, 2005, employers must complete the following steps:

1. Meet the deadline to amend the plan to conform to Section 409A

Notice 2005-1 imposes a deadline for making amendments to bring plans into compliance with Section 409A of December 31, 2005, and so employers will want to schedule in advance the steps that will need to be taken to accomplish this. Of course, employers will need to make design decisions and obtain corporate approvals of plan amendments well in advance of this date. But, in addition, employers will want to coordinate with record keepers to make sure that they are able to administer the design that the employer wishes to adopt and will want to leave time in their schedule for such consultation. For now, although plan drafting may not be possible until future Section 409A guidance is published, employers should be giving thought to broad questions of plan design so that they do not have to start from scratch when the new guidance is issued

2. Obtain participant distribution elections

Plan participants may also make new distribution elections with respect to prior deferrals until December 31, 2005, but after that date such elections will be treated as subsequent elections under Section 409A. As noted above, Section 409A requires that subsequent elections be made at least 12 months prior to the originally scheduled payout date, that they not take effect for at least 12 months, and that payments subject to the election are deferred for at least five years after the originally scheduled payout date.

The Treasury Department and the IRS have warned employers that future guidance is likely to adopt a more restrictive definition of performance-based compensation.

3. Terminate or cancel participant deferral elections for amounts deferred after 2004, if desired

Until December 31, 2005, participants may terminate or cancel deferral elections for amounts deferred after 2004 that are otherwise subject to Section 409A. Plans may therefore be amended to provide participants with the right to terminate or cancel deferral elections without causing the plan to violate Section 409A. If a participant terminates or cancels a deferral election, the amounts are includible in the participant's taxable income in the year the amounts are earned and vested. Under this transitional relief, however, no interest charge or penalty tax is imposed if participants terminate or cancel deferral elections in 2005

4. Terminate and pay out pre-2005 grandfathered deferrals, if desired

The complexity of the new Section 409A rules, and the harsh consequences of violations, may cause some employers to stop administering deferred compensation plans altogether. An employer in this position may terminate a grandfathered plan by terminating a participant's benefits completely and paying out deferred amounts in 2005 without the imposition of an interest charge or penalty tax. Employers who are considering this option should keep in mind that it may make a difference whether they terminate

the plan and pay out grandfathered amounts or merely offer participants a choice to receive a payment of grandfathered amounts. It may not be possible to offer grandfathered participants a choice of taking a payout or continuing grandfathered deferrals—the act of offering the choice may itself be a material modification and may also raise constructive receipt issues. The employer would in that situation be forced to amend the plan to conform to all the requirements of Section 409A.

5. Coordinate with payroll regarding reporting of distributed amounts as well as reporting of deferrals for 2005.

In addition to restricting distributions and elections under deferred compensation plans, the new rules impose new information reporting and wage withholding obligations on employers. Employers generally must provide annual reporting of all deferrals under a nonqualified deferred compensation plan in an employee's Form W-2 or an independent contractor's Form 1099-MISC, whether or not such deferrals are includible in the taxable income of the employee or independent contractor pursuant to Section 409A. Employers will also be required to withhold income taxes from deferred amounts that are includible in an employee's taxable income pursuant to Section 409A, but the Treasury Department and the IRS have not yet provided guidance on methods for computing the amount that can be included in an employee's taxable income under Section 409A.

As noted above, the transition rules permit employees to cancel elections or terminate participation in an existing plan until December 31, 2005, but employees who do so must include the amount in taxable income in 2005 (or, if later, in the year in which the amount is earned and vested). Employers will want to be prepared for payroll treatment of such amounts if cancellations or terminations are anticipated.

Conclusion

Although Section 409A imposes wide-ranging administrative burdens on employers and restrictions on employees, transitional relief under Notice 2005-1 provides employers with flexibility to adapt to the new rules over the course of 2005 so long as they operate plans in good faith compliance with the new rules. As further guidance becomes available, employers will be able to amend their plans to conform to Section 409A, but in the meantime they should keep in mind the schedule of available transitional relief as they strive to achieve compliance with the new rules. Although December 31, 2005, is the ultimate deadline for amending plans to comply with Section 409A, obtaining participant distribution elections, terminating or canceling participant elections, and even terminating pre-2005 plans entirely, the deadlines for initial deferral elections are earlier. Plan administrators should establish a general timetable for compliance and brace themselves to withstand the bumps along the way as we await more detail from the Treasury Department and the IRS on the intricacies of this new regime.

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