New Restrictions on Nonqualified Deferred Compensation:
The Effect of the American Jobs Creation Act of 2004

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Introduction

The American Jobs Creation Act of 2004, P.L. 108-357, signed into law by President Bush on October 22, 2004, adds a new section to the Internal Revenue Code, Section 409A, which imposes significant limitations on the design of nonqualified deferred compensation arrangements. Section 409A generally applies to compensation deferred after December 31, 2004 (see the "Effective Date" section below for more details). The primary focus of these new limitations is on the time of the election to defer, the time of payment, and the ability to modify the time of payment.

In a nutshell:

- **An election to defer compensation must be made before the first day of the year in which the compensation is earned. (There are exceptions for new participants and performance-based compensation.)**
- **The deferred payment date must be no earlier than the date employment ceases or a fixed identifiable date, except in the case of death, disability, an unforeseeable emergency or certain changes in the ownership of the employer.**
- **The payment date, once identified, can never be accelerated, and can only be further deferred for a minimum of 5 years, and only by complying with some restrictive rules.**
- **For purposes of these new rules, deferred compensation includes any arrangement to defer compensation that is not a qualified employer plan, whether it is elective or nonelective, whether it covers multiple employees or only one employee, and regardless of the form of the agreement.**
- **Failure to comply with these new rules will result in the immediate taxation of all amounts deferred by the participant to whom the failure relates, including significant interest and penalties. Noncompliance is not a rational option.**

This article provides an overview of the changes, focusing on those that are most likely to impact our clients. It reflects guidance issued by the Treasury and the Internal Revenue Service in late December 2004 (Notice 2005-1), which we will refer to as the "December 2004 Guidance."

Background – The Law Prior to Section 409A

Prior to the passage of Section 409A, the area of nonqualified deferred compensation was grounded in a patchwork quilt of court decisions dating back to the 1950's; IRS revenue rulings dating back 20 to 40 years; and IRS regulations involving constructive receipt and the transfer of property for services dating back to the 1950's and 1970's, respectively. It was an area of law with few bright line rules and many shades of grey.

Even the most basic question of when a deferral election must be made had no definitive answer. The IRS has long taken the position that an election to defer compensation should be made prior to the year in which the services are performed, but the decided case law does not back up that position. Most practitioners have assumed that the decision to defer compensation on an unfunded basis would not result in adverse tax consequences as long as the election was made prior to the earning of that compensation.

One thing that the IRS and practitioners agreed was that a key component in the design of unfunded deferred compensation programs was the avoidance of constructive receipt (being taxed when the income could have been received rather than when it was actually received). Accordingly, practitioners developed a variety of drafting techniques to avoid constructive receipt. One of the most common was to set a fixed date in a future year when the compensation would be paid, or to allow a participant to elect such a fixed date. Based on a liberal interpretation of some sparse case law, most practitioners also included a provision that permitted a participant to change the date on which the distribution would occur, either by further deferring it or by accelerating it, as long as the election to change was made more than a year prior to the date on which the distribution was due to be made. There were many variations on this theme of setting a date and then allowing for a modification. It was generally assumed that there was some degree of flexibility, but that it was a bad idea to get too aggressive. The IRS gave virtually no official guidance on these techniques.

Another technique for avoiding constructive receipt, known as the "haircut," would permit a participant to immediately accelerate a distribution scheduled to be made at a future date but, as a consequence, to forfeit a portion of the distribution (for example 5%) as the so-called "haircut." The theory was that the "haircut" was an adverse consequence, and that the imposition of an adverse consequence was enough to avoid immediate taxation that might have resulted from the participant's right to accelerate the distribution. Again, the IRS gave no guidance.

Separate and apart from the constructive receipt dilemma, prior to the passage of Section 409A, practitioners also worried about the risk of immediate taxation triggered as a result of a nonqualified deferred compensation benefit being funded, the so-called "economic benefit" doctrine. It was this doctrine that motivated the rise of the rabbi trust, a method of "funding" a benefit while maintaining its technical unfunded status by subjecting it to the claims of creditors, and thereby avoiding adverse tax consequences.

Why Congress Made the Changes

Congress undoubtedly was motivated by several factors in enacting Section 409A. One concern Congress had was that as nonqualified deferred compensation plans grew in popularity among the owners of companies, employers might be less motivated in the future to maintain their qualified plans that are made available to the non-highly compensated employees. This concern, coupled with news stories about companies on the brink of financial failure who funded their nonqualified plans at the "11th hour" as a way to benefit executives who oftentimes were the most responsible for the financial downfall of their companies, led Congress to believe that the time was right to set more comprehensive rules that allowed legitimate deferred compensation arrangements to continue to receive the desired benefit of deferring taxation, while eliminating that tax benefit for arrangements where the deferrals were subject to some form of potential manipulation by the company or the covered executive.

Scope of New Law - General

Section 409A applies to a "nonqualified deferred compensation plan," a term that is defined very broadly. Basically, it includes any arrangement that provides for a deferral of compensation other than a qualified employer plan (basically, a plan governed by Section 401(a), 403(a), 403(b) or 457(b) of the Code). The term includes both elective and non-elective programs, and covers any arrangement, even if it only involves one employee. For example, the new statute would govern an employment agreement that provided for a deferred payment in the future, even if on the face of the employment agreement there was no elective aspect as to the timing of the payment. In addition, the statute by its terms would include a bonus payable in a later year, and equity based compensation with a deferred payout based on the growth of the stock price. Although certain welfare plans (such as bona fide vacation leave, sick leave, compensatory time, disability pay or a death benefit plan) are specifically excluded, it is notable that severance pay is not excluded. Therefore, absent further guidance, the rules described below could be interpreted to apply to severance payments.

> *The December 2004 Guidance (Q-4) has made some helpful clarifications as to what constitutes a deferral of compensation. Basically, if compensation is paid in the year in which an employee first has a legally binding right to it, there is no deferral of compensation. Therefore, if under a program certain compensation can be reduced or eliminated by the employer in Year 1 but*

> *can no longer be reduced or eliminated in Year 2, and it is paid in Year 2, it does not constitute a deferred compensation plan. But the December 2004 Guidance warns that unlikely events that could result in divestiture, or technical changes that could reduce the amount, will not keep the program from being treated as a deferred compensation plan.*

Election and Payment Restrictions

Section 409A generally requires that the agreement or document describing the compensation contain certain election and payment restrictions set forth in the statute and discussed below, and that, in addition, the plan be operated in accordance with those requirements. As a result, virtually all deferred compensation plans, to the extent that they cover compensation deferred after 2004 (see the discussion below in the "Effective Date" section), will have to be amended to contain the restrictions set forth in Section 409A. The failure to comply with Section 409A results in the imposition of an immediate tax. Since the amount of this tax is substantial (and as a result punitive in nature), as discussed in more detail below, it is unlikely that anyone will want to risk non-compliance with Section 409A.

Rule No. 1– Minimum Earliest Distribution Date

Section 409A(a)(2)(A) provides that deferred compensation cannot be distributed earlier than one of six specified dates, as listed below:

i. separation from service (or, in the case of key employees of publicly-traded companies, 6 months after separation from service);
ii. becoming disabled;
iii. death;
iv. a fixed time (or a time determined pursuant to a fixed schedule) specified under the plan on the date of the initial deferral of such compensation;
v. a change in ownership, pursuant to regulations to be issued; or
vi. the occurrence of an unforeseeable emergency.

It is reasonable to conclude that Congress intended that a plan can provide for payment on the first to occur of any of these dates. In other words, a plan can pick a specified date (for example "attainment of age 65"), but then still provide that distribution will occur earlier than that date if any of the other listed events, including separation from service, occurred.

Rule No. 2 – No Acceleration of Time of Payment

The second rule is that once a time or schedule for distribution is set, it cannot be accelerated. Clearly, Congress views acceleration provisions as being inconsistent with the control that a participant must give up in order to receive the tax deferral benefits of deferred compensation. For example, electing to defer compensation to a future date but retaining the right to accelerate the payment calls into question whether giving up the right to immediate payment was more "form over substance" in the first place. Section 409A(a)(3) provides that a plan must not permit the acceleration of the time or schedule of any payment under the plan except as provided under the regulations to be issued. This rule appears not only to prevent an acceleration of a previously-made election, but also to prevent a company from unilaterally accelerating the time or schedule of a payment under a nonqualified deferred compensation plan. The rule seems to be that once a promise is made to pay deferred compensation at a specific time, or upon one of a number of different events, that promise cannot be amended if the amendment would lead to the acceleration of the payment of benefits.

> *The December 2004 Guidance (Q-15) has clarified that a unilateral acceleration of vesting is not a violation of Section 409A. For example, if a plan provides for distribution upon separation from service, and A is not scheduled to vest until 2009, a decision by the employer to vest A in 2006, upon A's termination of employment, is not a violation of Section 409A.*

> *The December 2004 Guidance also provides for certain exceptions to the rule prohibiting acceleration; payments pursuant to a domestic relations order, payments under a Section 457(f) plan to cover current income taxes, payment to cover FICA taxes, and the amendment of a plan to provide for a complete lump sum cash out upon termination of employment of not more than $10,000 are all permitted.*

Rule No. 3 – When Initial Election Must be Made (Actually 3 Subrules)

There are three special rules (we will refer to them as "subrules" here) on when a deferral may be made at the participant's election. These subrules apparently do not apply to deferred compensation that is awarded by a company automatically and not subject to a participant's election.

The first subrule is that compensation for services performed during a year can be deferred by election only if the election is made by the close of the preceding year. For a nonqualified "401(k) type" plan, the deferral election for a calendar year must be in place by the December 31 of the preceding year.

The second subrule, an exception to the first, is that in the first year of eligibility in an elective plan, an election to defer can be made during the plan year with respect to future services if the election is made within 30 days after the participant becomes eligible to participate in the plan. In other words, the election does not have to be made in the previous year.

The <u>third and final subrule</u> regarding elective deferrals of compensation, adds another exception to the first subrule that the election must be made in the prior year, for performance-based compensation based on services performed over a period of at least 12 months. This includes annual bonuses and many incentive compensation plans. With respect to this type of compensation, if an election to defer is provided, an initial election to defer can be made no later than 6 months before the end of the period of coverage.

The term "performance-based compensation" is not defined in the statute, but the legislative history to the statute explains that this term refers to a variable pay plan that measures company and individual performance over a set coverage period, so the amount of the pay being deferred is not known as of the time of the deferral election. The legislative history clarifies that the term does not include stock bonuses that are issued with a stock price that is at or above the market price, but that it does include stock appreciation rights and other stock-based deferred compensation that is paid in cash.

> *Until further guidance is issued, the December 2004 Guidance (Q-22) provides for an expansive definition of performance-based compensation. Under this definition, compensation will be considered performance-based where (a) the payment or amount of such compensation is contingent on the satisfaction of organizational or individual performance criteria, and (b) such performance criteria are not substantially certain to be met at the time a deferral election is permitted. The December 2004 Guidance specifically notes that performance-based compensation may include payments based on subjective performance criteria, within certain parameters. In addition, the performance criteria need not be approved by a compensation committee of the employer's board of directors or by the employer's stockholders. The December 2004 Guidance does make it clear that an amount that will be paid based on the value of, or appreciation in value of, the employer or the employer's stock will not be considered performance-based compensation. Finally, the Treasury and the IRS have indicated that future guidance will likely impose more restrictive requirements on what amounts constitute performance-based compensation.*

It is possible that under this Rule No. 3 (composed of the three subrules explained above), an election to defer compensation will have to be made long before a right to compensation becomes vested. For example, assume that an employee is promised a payment of $100,000 on July 1, 2008, or a later date if an election is made to defer, but only if the employee remains employed from January 1, 2005 through December 31, 2007. Presumably, this compensation is not "performance based," so the exception contained in the third subrule, would not apply. Pursuant to the first or general subrule, an initial election to defer payment beyond July 1, 2008, would have to be made prior to January 1, 2005, the first year with respect to which the deferred compensation is earned. The statutory history suggests that there might be some loosening up of the rules when deferred compensation is earned over a multi-year period, such as by only requiring the election to be made prior to the last year of the multi-year period. We will have to await further guidance.

Rule No. 4 – When Can a Subsequent Election be Made?

The last of Section 409A's rules regarding elections and distribution dates applies to a plan "which permits under a subsequent election a delay in a payment or a change in the form of payment." Although this language sounds like it presupposes that there was an initial election, it seems more likely that it also refers to compensation that was deferred without an election, but which may be further deferred by a subsequent election. According to Section 409A, there are three restrictions on such a subsequent election:

1. The first restriction is that the subsequent election may not take effect until at least 12 months after the date it is made. In other words, during the 12-month period beginning on the date of the subsequent election, the subsequent election is treated as if it has not been made.

2. The second restriction is that, in the case of a subsequent election not related to death, disability or an unforeseeable emergency, the further deferral must be for a period of at least 5 years, as measured between the first payment prior to the subsequent election and the first payment pursuant to the subsequent election. This rule applies to a subsequent election related to a specific date, as well as to a payment related to separation from service. It is not clear how to apply this 5-year rule to a subsequent election that, for example, changes the first payment date from January 1, 2008 to separation from service.

3. The third restriction is that, if the election is related to a payment due on a specific date (rather than a payment due to separation from service, death or disability), the election must not be made less than 12 months prior to the date of the first scheduled payment. This goes beyond the first restriction, (1) above, which focuses on when the election becomes effective – the election described in this paragraph (3) will never become effective. This rule only applies to the subsequent deferral of an amount to be paid on a specific date.

Funding Rules

Section 409A has only a few rules relating to funding and they will not impact most plans. Unlike the election and payment restriction rules, these rules do not need to appear in the deferred compensation plan. If these rules are violated, as described below, the adverse tax consequences under Section 409A would result.

The first funding rule is that if assets set aside in a rabbi trust to pay deferred compensation are located outside the United States, they will be treated as transferred to the participant and therefore immediately subject to the taxes, interest and penalties imposed under Section 409A. For example, it will no longer be possible to establish a rabbi trust with a Bermuda-based bank as trustee and with assets held in a foreign bank account. This will result in immediate taxation even if the assets are available to satisfy the claims of the employer's unsecured creditors. This rule eliminates the possibility of funding a rabbi trust with assets located outside the United States.

The second funding rule is that if a plan provides that assets in a rabbi trust must be used to provide deferred compensation benefits upon a change in the employer's financial health, the assets will be treated as transferred to the participant and therefore immediately subject to the taxes, interest and penalties imposed under Section 409A. This rule eliminates the possibility of designing a rabbi trust that converts to a funded trust in the event of the employer's financial deterioration in order to give executives an advantage over the employer's other unsecured creditors. The mere existence of such a provision will result in immediate taxation.

Application to Employment Agreements

Section 409A will apply to any arrangement that involves the deferral of compensation, whether it is in a formal plan that applies to multiple employees, or in an individual's employment agreement. Therefore, if an employment agreement provides for a deferred payment that is legally binding and vested in a year earlier than the year of payment, the employment agreement is a deferred compensation plan and will have to comply with both the formal and operational requirements of Section 409A.

> *The December 2004 Guidance (Q-4(a) and (c)) has clarified that if the employment agreement simply provides for a deferred payment that requires further service for vesting, and is then paid out in the year it vests (like a stay bonus), that provision will not be considered a deferral of compensation. Nonetheless, the Treasury and the IRS have expressed some concern about arrangements that purport to involve a vesting requirement with payment upon vesting, where the parties do not intend for such provisions to be enforced. Further guidance related to this concern may be forthcoming.*

Application to Bonuses

Many employers, large and small, provide for annual bonuses that are determined and paid early in the year following the year earned. Very often vesting occurs as of the end of the year, although sometimes the employee must remain employed on the payment date to receive the bonus. If these programs are considered deferred compensation plans, then all of the formal and operational requirements described above would apply to them.

> *The December 2004 Guidance (Q-4(c)) provides that, until additional guidance is issued, a short-term deferral (not lasting beyond the later of 2½ months after the end of the employee's tax year in which the bonus becomes vested, or 2½ months after the end of the employer's tax year in which the bonus becomes vested) will not constitute a deferral of compensation. If, however, the program permits an employee to elect a further deferral, and an employee makes that election, then for that employee the bonus is a deferred compensation plan.*
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> *It should be noted that this 2½ month rule is not limited to bonus programs: any arrangement that makes payment within 2 ½ months after the end of the tax year of the employer in which the employee's right to the payment first becomes vested will not constitute a deferred compensation plan.*

<u>Application to Severance Plans</u>

The exclusion of welfare plans from the definition of deferred compensation plan in Section 409A created an inference that severance plans had to comply with the new rules to the extent that payments were deferred into a year subsequent to termination from service. This means that every severance plan would have to comply with the formal requirements of Section 409A, would not be able to permit a further elective deferral or an acceleration of payments, and would be subject to the 6 month delay in payment for key employees of publicly traded companies.

> *Although no permanent relief is provided, the December 2004 Guidance (Q-19(d)) does provide a one-year respite for 2005 for certain severance plans. A severance plan (as defined below) will be treated as not covered by Section 409A for 2005 if it is either collectively bargained or does not cover any key employees. While not entirely clear, the definition of severance plan for this purpose appears to require that both of the following conditions be met: 1) the plan does not constitute a pension plan (payments not contingent on retirement, for not more than 24 months and for not more than 200% of final annual pay), and 2) the plan provides benefits only upon involuntary termination. In any event, we expect most companies' severance plans to meet both conditions. This temporary rule may mean that Treasury is*

considering some permanent relief along the same lines, but we will have to wait and see.

Application to Equity Based Compensation

Stock options and stock appreciation rights (SARs), while a form of deferred compensation, have always been treated under their own, very favorable tax rules, derived from Section 83 of the Internal Revenue Code. The legislative history of Section 409A made it clear, however, that at least some forms of this equity based compensation would be included in the ambit of Section 409A.

The problem is that one of the hallmarks of stock options and SARs is that the exercise of the option or right is made by the participant at his or her election, presumably when the stock has appreciated significantly. Yet Section 409A requires that deferred compensation be received at a fixed time in the future, thereby eliminating the critical factor of flexibility regarding the time of exercise. There is therefore great anticipation to see what forms of equity based deferred compensation will be subject to Section 409A.

The December 2004 Guidance (Q-4(d)) provides a lot of information about equity based compensation.

a. *Statutory (or Incentive) Stock Options. ISOs issued pursuant to Section 422 of the Code and options granted under an employee stock purchase plan under Section 423 of the Code do not constitute a deferral of compensation, and therefore are not subject to Section 409A.*

b. *Nonstatutory Stock Options. An option not described in (a) above will not constitute the deferral of compensation if the following rules are met: i) the strike (exercise) price can never be less than the fair market value of the stock on the date the option is granted; ii) the taxation of the option is otherwise subject to Section 83 of the Code; and iii) there is no mechanism for further deferral after the exercise or disposition of the option. Otherwise, the stock option is subject to Section 409A.*

c. *Stock Appreciation Rights (distinguished from options by the fact that no stock is ever purchased). Generally, a SAR will not constitute the deferral of compensation if the following rules are met: i) the strike price can never be less than the fair market value of the stock on the date the SAR is granted; ii) the stock of the employer is traded on an established securities* *exchange; iii) only such traded stock – not cash – can be delivered upon exercise of the SAR; and iv) there is no mechanism for further deferral after the exercise of the SAR. Otherwise, the SAR is subject to Section 409A.*

Until further guidance is issued, there is a special rule for SARs issued pursuant to a program in effect on or before October 3, 2004. SARs under such programs can have a payment of cash or stock upon exercise, and need not have stock that is traded on an exchange. In other words, such a program only needs to comply with i) and iv) above.

<u>The Special Problems of Not-for-Profit and Governmental Deferred Compensation</u>

Governmental entities (since 1979) and not-for-profit entities (since 1987) have had to deal with greater problems than the for-profit world in offering nonqualified deferred compensation. These plans have been subject to Section 457(f) of the Code, pursuant to which deferred amounts are taxable as soon as they are vested, regardless of whether they are funded or unfunded. For that reason, virtually all deferred compensation plans provide for immediate payment of vested amounts.

Consequently, the only way to achieve any flexibility with respect to payments was by deferring the vesting event. This is generally accomplished by determining a vesting date that balances the participant's desire to have a vested right to the compensation and the preference to defer the time of taxation. In some cases, plans have allowed participants to defer a vesting date by requiring an additional period of continued employment in order to defer a taxable event (sometimes referred to as a "rolling risk of forfeiture"), with the understanding that the participant was taking a real risk that the deferred amount might never vest if he or she terminated employment in the interim.

Section 409A applies to the deferred compensation plans of not-for-profit and governmental entities, and some of the rules, notably the time for electing a deferral and the restriction on accelerating a payment date, may require changes in the operation of such programs. The bulk of the provisions, however, relating to elections to defer (see Rule #4 above) are inapplicable because taxation will continue to be immediate upon vesting regardless of the payment date. There is justified concern, however, based on statutory language, that the Treasury, in its regulatory guidance, may promulgate new rules on when the delay of a vesting date will be disregarded in determining the taxation of nonqualified deferred compensation provided by not-for-profits and governmental entities. Caution should be observed in the meantime in the design of new programs or in the continued deferral of vesting (via "rolling risks of forfeiture") in the operation of existing programs.

The December 2004 Guidance (Q-10) in fact has made it clear that any addition of a substantial risk of forfeiture after the beginning of the service period will be disregarded for purposes of determining whether a deferred payment is subject to a risk of forfeiture. This means that if a Section 457(f) plan has a rolling risk of forfeiture, any rolling back of the vesting date will be seen as a further deferral of a vested benefit, and if it is in violation of Section 409A because the delay is less than 5 years, the rolling back will constitute a violation of Section 409A.

As noted under "Rule No. 2" above, the December 2004 Guidance permits a 457(f) plan to accelerate the payment of an amount necessary to pay the income tax due in the year vesting occurs.

Tax Consequences of Noncompliance

As noted above, the tax consequences of violating any of the requirements of Section 409A are onerous. First of all, for any participant to whom the failure relates, there will be immediate inclusion in gross income of all compensation deferred for the current taxable year and all previous taxable years, to the extent vested. Second, the amount included will be increased by interest from the date an amount was first deferred, or the date it became vested if later. The interest rate will be the federal underpayment rate plus 1%. Finally, the tax will be increased by 20% of the compensation required to be included in gross income (not including interest).

Reporting Obligation

As part of the new law, employers will now be required to report, on an annual basis, the amounts of compensation deferred in a taxable year, even though the amount is not taxable in that year. Employers will use Form W-2 for employees and a specific new box will be provided for this purpose. The Form 1099 will be used for individuals other than employees, like independent contractors. This is the first time that information on amounts deferred under nonqualified deferred compensation plans will be reported to the IRS prior to the inclusion of those amounts in the participant's taxable income.

> *The December 2004 guidance (Q-24 to Q-38) provides some additional specifics about the reporting and withholding obligations, although some issues (like the method for calculating the amount of deferred compensation for 2005 and each year thereafter) are still unresolved. The December 2004 Guidance indicates that the total amount of compensation deferred for a person during the taxable year after December 31, 2004, including income attributable to such compensation, is reported either: (1) in Box 12 of the Form W-2 using a new Code Y or (2) in Box 15a of the Form 1099-MISC. In addition, until further guidance is issued, employers are not required to report deferrals of $600 or less for an employee on the Form W-2. (The Instructions for the Form 1099-MISC already contain a similar exception for amounts not in excess of $600.) The December 2004 Guidance also makes clear that, to the extent the amount deferred under a non-account balance nonqualified deferred compensation plan is not "reasonably ascertainable," such amount is not required to be reported on either the Form W-2 or the Form 1099-MISC.*
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> *The December 2004 Guidance further indicates that when deferred compensation (and earnings thereon) are includible in an employee's income, those amounts are to be reported on Form W-2 in Box 1, and in Box 12 using a new Code Z. Amounts includible in the income of a non-employee to whom the Form 1099-MISC reporting requirement applies are reported in Box 7 and Box 15b of the Form 1099-MISC. Finally, if an employer must provide a Form W-2 before guidance is issued on calculating the amount of deferrals, the December 2004 Guidance provides that the employer must issue a corrected Form W-2 once the guidance is issued, presumably where the initial amount must be increased or decreased.*

Effective Dates

There has been some initial confusion about the effective date of Section 409A. On its face the effective date rules are simple: Section 409A applies to compensation deferred after December 31, 2004, and does not apply to compensation deferred on or prior to that date. In addition, Section 409A does not apply to post 2004 earnings on deferrals made on or prior to December 31, 2004. Finally, a grandfathered (pre 2005) plan will become subject to Section 409A if it is materially modified after October 3, 2004.

The confusion relates to how to identify whether a deferral is made on or prior to December 31, 2004. For example, if a bonus is paid for 2004, but the actual payment date is in April, 2005, with a requirement that a participant still be employed on the payment date to get the bonus, will it be seen as a 2004 or a 2005 deferral? Furthermore, if a plan established in December, 2002 provides for a deferred payment in January, 2006 based on annual awards for 2003, 2004 and 2005, is all of the deferred compensation post 2004, or can it be bifurcated into grandfathered (pre 2005) deferrals and post 2004 deferrals? These questions have not been answered in the legislation, although there is initial speculation that the critical factor will be whether the deferrals were vested on December 31, 2004, or whether some further act, such as continued employment in 2005 or thereafter, was required.

The December 2004 Guidance (Q-16) in fact has made it clear that amounts will be treated as grandfathered (pre-2005) deferrals (that are not subject to Section 409A) if: 1) the employee has a legally binding right to be paid prior to January 1, 2005, and 2) the right to the payment is earned and vested prior to January 1, 2005. In addition, the Treasury and IRS have given guidance (Q-17) on how to calculate the amount that was legally binding and vested prior to January 1, 2005. The post-2004 earnings on such amounts are also treated as pre-2005 amounts, and earnings are deemed to include the actuarial increase in the value of a non-account balance plan and the increase in value due to an increase in stock price in an equity based plan.

The December 2004 Guidance (Q-18) also explains under what circumstances an otherwise grandfathered plan will become subject to Section 409A because it is "materially modified." A Plan will be considered materially modified if, by virtue of an amendment or the exercise of discretion by the employer, a benefit or right is enhanced, or a new benefit or right is added. It is not a material modification to add an investment option, to amend a plan to bring it into compliance with Section 409A, or to reduce an existing benefit.

Amending an arrangement to stop future deferrals and thereby preserve the grandfathered status of the arrangement will not constitute a material modification. In this same spirit, a stock option or SAR (see above) that does *not meet the criteria for exclusion from Section 409A coverage can be replaced by a stock option or SAR that does meet the criteria for exclusion, without constituting a material modification, as long as such substitution occurs by December 31, 2005.*

Finally, the December 2004 Guidance makes it clear that if an existing plan provides for new benefits, the new benefits will be subject to Section 409A, but the addition of such benefits will not constitute a material modification that will subject the previously granted benefits to Section 409A.

What should employers do now?

Every employer that offers a deferred compensation arrangement that is covered by Section 409A will want to comply with its requirements. Noncompliance is not a rational option. But how and when should compliance be accomplished? The Treasury is required to issue transition relief within 60 days of the law's enactment, in other words by December 21, 2004. It is expected that Treasury will give significant transition relief for existing programs. We therefore think that it would be a mistake to amend plans or procedures prior to the date the transition relief is promulgated. We anticipate giving our clients further guidance shortly after the relief is issued. In the meantime, employers should continue to implement the election procedures provided under ongoing plans, such as making elections in December, 2004 for the deferral of 2005 compensation. In addition, this is a good time to take inventory of all plans, programs and contracts that might constitute a nonqualified deferred compensation plan under Section 409A.

In the long run, employers with deferral programs that offer greater flexibility than Section 409A allows will have to either be amended or frozen. If the plans are amended, then the flexibility for changing deferral elections may be lost even for pre-2005 deferrals (since the amendment may be considered a material modification and therefore subject to Section 409A). If the plans are frozen, or divided into pre-2005 and post-2004 portions, then the flexibility for pre-2005 deferrals may be preserved. Many employers may decide that this flexibility is outweighed by the complexity of having two separate sets of rules on an ongoing basis.

The December 2004 Guidance (Q-19) provides substantial guidance regarding plan operation and drafting during 2005. These rules are not applicable to grandfathered plans, but only to plans that are subject to Section 409A.

a. Good Faith Compliance. During 2005, a plan must be operated in good faith compliance with Section 409A, using the issued guidance and a reasonable interpretation of Section 409A.

b. *<u>Coordination with Qualified Plans.</u> For 2005, an election regarding payment of benefits that is controlled by a payment election under a qualified plan will be deemed not to violate Section 409A, even though it may permit a participant to have discretion about the time and form of payment that would otherwise violate Section 409A. There is no similar guidance as to any other coordination issues – notably, there is no official guidance on the fate of supplemental 401(k) plans that commence deferrals if and when the Section 402(g) cap on deferrals under the qualified 401(k) plan has been reached, although there is unofficial pessimism about whether such plans can continue to exist.*

c. *<u>Optional changes in election by March 15, 2005.</u> A participant may make a new election, or change an existing election, with respect to post-2004 deferrals as late as March 15, 2005, provided all of the following conditions are satisfied:*

   i. *the amounts to which the election relate have not yet become payable;*

   ii. *the plan is in existence and in writing on or before December 31, 2004;*

   iii. *the election is made in accordance with the terms of the plan, other than the fact that it is being made in 2005; and*

   iv. *the plan is operated in good faith compliance and amended to comply with Section 409A by December 31, 2005.*

d. *<u>Required compliance by December 31, 2005.</u> Every deferred compensation plan to which Section 409A applies must be amended to comply with Section 409A by December 31, 2005. The Treasury and IRS have stated that they will issue additional guidance in the first part of 2005. It is possible that such guidance, or subsequent guidance, will include pre-approved language, and therefore, in general, we do not advise amending any plan at this time.*

e. Optional amendments by December 31, 2005. The December 2004 Guidance (Q-19 and Q-20) permits the following amendments to be made in 2005 without violating the terms of Section 409A or causing an adverse tax result:

i. A plan may be amended to add a new payment election with respect to amounts deferred prior to the election, as long as the plan is amended and the election is made by December 31, 2005. Without this rule, the election might be viewed as an acceleration, or a further deferral, that is not permitted under Section 409A.

ii. A plan may be amended to terminate an employee's participation, or to cancel a deferral election that was previously made, even though such amendment, or such election, would otherwise be an acceleration or otherwise in violation of Section 409A. Similarly, any distribution made as a result of such election, if made in 2005 (or upon vesting if later), will not be treated as a violation of Section 409A.

For many years, practitioners have lived with the threat that Congress would crack down on the largely ungoverned nonqualified deferred compensation world. That crackdown has now begun with Section 409A. It may or may not be the last word (other than the implementation of these changes). Whatever the case may be, employers will have to be aware of the new rules in order to evaluate what changes need to be, or should be, made to their nonqualified deferred compensation programs.

If you have any questions regarding the new deferred compensation rules, please contact any member of the Employee Benefits Practice Group:

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