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New Deferred Compensation Rules Require Immediate Action

by David H. Phillips and Donald R. Saxon

Legislation imposing new restrictions on a wide range of compensation arrangements was signed into law on October 22, 2004. The American Jobs Creation Act (AJCA) adds a new section 409A to the Internal Revenue Code, which imposes restrictions on funding, distributions, and elections to participate in nonqualified deferred compensation plans. While IRS guidance (IRS Notice 2005-1) provides some generous transitional relief, immediate changes will be necessary for many deferred compensation arrangements.

Who is Subject to Section 409A?

The new section 409A covers a broad spectrum of arrangements, including existing plans and some or all of the contributions previously made to them. By its terms, section 409A applies only to amounts deferred pursuant to a "nonqualified deferred compensation plan," on or after Jan. 1, 2005. Any arrangement which postpones payment of compensation to another year, has the potential to be a nonqualified deferred compensation plan. Notice 2005-1, the only IRS guidance relative to section 409A issued at the time this article went to publication, confirmed that the term was intended to include arrangements covering only one person, severance agreements, Supplemental Executive Retirement Plans (SERPs), "defined benefit" nonqualified plans, and arrangements with non-employees (*e.g., directors and trustees*). The statute identifies very few exceptions, the most significant of which are qualified plans, time-off plans and certain stock option arrangements.

> For example, an agreement with a departing executive to pro-rate payment of her severance package over the next 24 months will fall within the scope of the new Section 409A.

While the new law is nominally limited to amounts deferred on or after Jan. 1, 2005, the enabling legislation and the IRS's method of determining when compensation is deemed to be deferred will effectively broaden this application. AJCA, but not section 409A proper, provides that any amounts deferred pursuant to a nonqualified deferred compensation plan that is "materially modified" after Oct. 3, 2004 will be subject to section 409A, regardless of the date of actual deferral. While a material modification does not include an amendment made to comply with section 409A, it would include the enhancement or addition of a benefit or right. In addition, amounts which had not vested prior to section 409A's effective date are deemed to have been contributed on the date they vest, thus making them subject to section 409A.

What Restrictions Does Section 409A Impose?

Section 409A provides that unless the requirements identified below are both included in the plan and enforced, all compensation deferred into a nonqualified deferred compensation plan will be subject to immediate taxation, plus interest (at the general late-payment rate plus 1 percent) back to the date the compensation was deferred, plus a penalty of 20 percent of the deferred compensation. The requirements fall into three categories: distributions, deferral elections and funding.

Distributions. Section 409A permits deferred compensation to be distributed only upon the earliest of: (1) separation from service (but key employees of publicly traded companies must wait an additional six months), (2) disability (as defined in the statute), (3) death, (4) unforeseeable emergency (which is not the equivalent of a 401(k) plan "hardship" and which has not yet been defined by the IRS) and (5) a date irrevocably designated at the time of the deferral elections. Neither the "irrevocable" dates nor the form of distribution (e.g., monthly installments over a fixed period of years) may be accelerated once elected. The "irrevocable date" may be postponed, but only if such postponement is made at least 12 months prior to such date and the new distribution date is at least five years after the original date.

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> For Example, as part of her initial election to participate in her employer's nonqualified deferred compensation plan, Employee A elects to receive a $10,000 distribution on Mar. 31, 2007. Absent the occurrence of one of the other distributable events described above, that $10,000 payment may be made no earlier than Mar. 31, 2007. However, the plan may permit Employee A to elect, before Mar. 31, 2006 (more than 12 months prior to the distribution date) to postpone this $10,000 payment to any date on or after Mar. 31, 2012 (five years from the originally scheduled date of distribution).

It is clear from the legislative history of AJCA that Congress anticipated that all nonqualified deferred compensation plans either already did require, or would interpret section 409A as requiring that participants elect both the time and form of distribution simultaneously with their election to participate. Notice 2005-1 maintains this assumption. However, not only do many nonqualified deferred compensation arrangements have no such provisions, but section 409A contains no such requirement. The unfortunate result is that neither the statute nor Notice 2005-1 offers much guidance as to how the prohibition against changing one's election applies when no previous election has been made.

Deferral elections. The general rule of section 409A is that compensation may be deferred to a nonqualified deferred compensation plan only if the election to defer such compensation is made prior to the taxable year in which the compensation is earned. Two significant exceptions are made, however. First, a newly eligible employee may elect to defer compensation which would have been paid during the year of the election, as long as such election is made within 30 days of the date the employee was first eligible to participate and before the performance of the services which generate the compensation to be deferred. Second, in the case of "performance-based compensation," which Notice 2005-1 refers to as "bonus compensation," for which the relevant performance period is 12 months or more, the election to defer such compensation may be made until six months before the end of the period. Although not directed to do so by section 409A or AJCA, the IRS, in Notice 2005-1, provided a fairly restrictive definition of bonus compensation, and went on to indicate that this definition would be further restricted in the future.

Notice 2005-1 limits bonus compensation—and therefore "performance based compensation"—to compensation, the payment of which is contingent on the satisfaction of performance criteria which are not substantially certain to be met at the time a deferral election is permitted. The criteria may be subjective, but only if they relate to the performance of the participant (either individually or as part of a group or business unit), and the determination that the criteria have been met is not made by the participant or a family member. While this latter requirement sounds reasonable, participation in nonqualified deferred compensation plans is essentially limited to the types of persons who make such subjective determinations. In a small organization, it may not be possible to classify some bonuses as performance based compensation for section 409A purposes.

Funding. Section 409A does not, as some earlier proposed legislation attempted to do, prohibit the use of so-called Rabbi Trusts. Rabbi Trusts are funding vehicles for nonqualified deferred compensation plans which protect such a plan's assets from use by the employer, unless and until the employer becomes insolvent, at which time the Rabbi Trust's assets are subject to the claims of the employer's creditors. Though permitting their continued use, Section 409A does limit Rabbi Trusts in two ways. First, neither the Rabbi Trust nor its assets may be located outside the United States. Second, the Rabbi Trust may not contain any provisions, which purport to place the rights of participants ahead of the rights of general creditors upon a change in the financial health of the employer.

Transition to the New Rules

A prerequisite for the transitional relief included in Notice 2005-1 is that the plan be operated in good faith compliance with existing guidance and the current terms of the plan itself—to the extent not in conflict with the guidance—until the plan document is actually amended (see below). This means that the plan must immediately begin to operate in accordance with section 409A, even if this conflicts with the written terms of the plan.

For some plans, because pre-2005 deferrals are not necessarily subject to the new rules, the only immediate impact will be on the solicitation of participant elections. As noted above, section 409A requires these elections to be made prior to the relevant year. Of course, this means that the elections to defer 2005 compensation must have been made during 2004. Because the IRS did not publish Notice 2005-1 until Dec. 20, 2004, and then amended it Jan. 6, 2005, the Notice included a

grace period for implementation of these election rules. Plans already in existence in 2004 could permit—if not inconsistent with the plans' current provisions—participants to make elections relative to their 2005 compensation as late as Mar. 15, 2005, provided the election was made before the amounts were earned.

> The Notice also fails to identify whether the transitional right to elect a new form of distribution or payment option may be used to elect an option not previously available under the plan ...

Notice 2005-1 also contains some very generous transitional rules for current participants in existing nonqualified deferred compensation plans. It allows a plan that was in existence prior to 2005 to be amended to permit participants, during 2005 only, to terminate participation in the plan, to cancel an earlier deferral election, to reduce the amount of an earlier deferral election or to elect a new form of distribution or new payment option. Further, if a participant elects to terminate participation, the plan may permit that participant's account to be distributed immediately, as long as it is immediately taxable to the participant (but without triggering the interest or penalty provisions). Similarly, if a previous election is reduced or cancelled, any previously deferred compensation, no longer subject to the election, may be returned and is immediately taxable.

The Notice does not indicate whether this election to terminate participation must be permanent, precluding any future contributions. While it would seem logical to exclude a participant who elects to terminate participation under this provision from deferring any 2005 compensation, this is not expressly required. The Notice also fails to identify whether the transitional right to elect a new form of distribution or payment option may be used to elect an option not previously available under the plan, but which has been added in 2005.

While these rules may ease the transition from pre-AJCA to post-AJCA nonqualified plan participation, arguably an amendment to utilize these rules would be a material modification, causing the entire plan and all previously deferred amounts to become subject to section 409A.

Fortunately, the IRS has acknowledged that more specific guidance and more time are required before sponsors of nonqualified deferred compensation plans can reasonably be expected to fully comply with section 409A. Therefore, formal amendment of nonconforming deferred compensation plans may be postponed until the end of 2005, as long as the plan is operated, in the interim, in "good faith" compliance with the provisions of section 409A and the Notice.

By the end of 2005, every deferred compensation plan subject to section 409A must be amended, even if only to formalize existing procedure, or conform terminology to the language of the new law. Also, by this same date, administrators of these plans must be prepared to implement the new distribution rules for amounts deferred in 2005 or later. In some cases, this may require that different portions of a participant's accumulated deferred compensation be handled in distinctly different manners. An administrator will want to ensure that the plan's recordkeeping and documentation process is prepared for this possibility.

David H. Phillips is an associate with the law firm of Gallagher, Callahan & Gartrell, Pa. He may be reached at *phillips@gcglaw.com.*

Donald Saxon is of counsel to the law firm of Gallagher, Callahan & Gartrell, Pa., and is an assistant professor of Accounting at Westminster College in Salt Lake City, Utah. He may be reached at *saxon@gcglaw. com.*