THE NOT-SO-BRAVE NEW WORLD OF DEFERRED COMPENSATION

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Section 885 of the American Jobs Creation Act of 2004 (the "Act") added section 409A to the Internal Revenue Code (the "Code"), providing new rules for the design and operation of nonqualified deferred compensation plans (NQDCPs). The Act demands prompt attention from almost all tax practitioners who advise business or professional clients, because of the breadth of the definition of NQDCP, the scope of the changes that will be required to most plans (many of which will require significant lead time to design and implement) and the December 31, 2005 deadline for adopting certain changes. Section 409A does not change the rules governing the timing of the employer's deduction, which is still governed by section 404(a).

On December 20, 2004, IRS issued Notice 2005-1, 2005-2 IRB 274, the first guidance on the new rules. Treasury and IRS have now issued the long-awaited proposed regulations, 70 FR 57930 (Oct. 4, 2005). In general, the proposed regulations incorporate the guidance in Notice 2005-1 and provide substantial additional guidance. Taxpayers may rely on the proposed regulations until the effective date of the final regulations and some, but not all of the transition relief provided for 2005 by the Notice has been extended through 2006.

Section 409A is a response to the abuses revealed by the Enron hearings rather than a coherent and comprehensive approach to the taxation of nonqualified deferred compensation. According to the Joint Committee on Taxation:

"Many nonqualified deferred compensation arrangements had developed which allowed improper deferral of income. Executives often used arrangements that allowed deferral of income, but also provided security of future payment and control over amounts deferred. For example, nonqualified deferred compensation arrangements often contained provisions that allowed participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a "haircut" provision)." Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (General Explanation), JCS-5-05, May 2005, at 469.

EFFECT OF NONCOMPLIANCE

If, at any time during a taxable year, a NQDCP fails to meet the requirements summarized below, in form or in operation, then all compensation deferred under the plan for the taxable year ***and all preceding taxable years*** will be includible in the gross income of those participants to whom the failure relates, to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

The amount of income tax imposed will be increased by (1) interest (at the underpayment rate plus 1%) on the underpayments that would have occurred had the deferred compensation been includible for the taxable year in which first deferred or, if later, the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture; plus (2) an amount equal to 20% of that compensation.

DISTRIBUTION RESTRICTIONS

Compensation deferred under the plan may not be distributed earlier than

1. Separation from service (special rules apply to any "key employee" of a corporation whose stock is publicly traded);

2. The date the participant becomes disabled (the definition of disability is restrictive);

3. Death;

4. A time or fixed schedule specified at the time of the deferral;

5. To the extent provided by the Secretary, a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of its assets (until regulations covering such changes in partnerships are issued, taxpayers may apply Prop. Reg. §1.409A-3(g)(5) by analogy); or

6. The occurrence of an unforeseeable emergency.

ACCELERATION OF BENEFITS

The plan may not permit acceleration of the time or schedule of any payment under the plan (e.g., from an annuity to a lump sum), except as provided in regulations. This will prevent haircut withdrawal rights and triggers. There are exceptions where the accelerated distribution is required for reasons beyond the control of the participant and for automatic distributions of minimal amounts upon a permissible distribution event.

All the permissible payment accelerations contained in Notice 2005-1, Q&A-15, are included in the proposed regulations. The proposed regulations also provide that a plan may permit the acceleration of any amount included in income as a result of the plan failing to meet the requirements of section 409A.

The statute does not provide for acceleration by reason of termination of the plan. The proposed regulations provide three circumstances under which a plan may be terminated at the discretion of the service recipient, and further guidance establishing criteria for plan terminations is being considered.

The proposed regulations include rules under which NQDCPs linked to qualified plans may continue to operate, though certain changes may be required. The intent is to permit the qualified plan to be established, amended and operated under the rules governing qualified plans, without causing the NQDCP to violate section 409A.

DEFERRAL ELECTIONS

There are new requirements governing the timing and effectiveness of both initial deferral elections and subsequent deferral elections to delay a payment or change the form of payment.

TRUSTS AND OFFSHORE PROPERTY

If assets are set aside in a trust or other arrangement to pay deferred compensation under a NQDCP, then for purposes of section 83 such assets will be treated as property transferred in connection with the performance of services, regardless of whether the assets are available to the employer's general creditors. This rule does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the deferred compensation relates are performed in that jurisdiction.

EMPLOYER'S FINANCIAL HEALTH

There is also a section 83 transfer of property as of the earlier of:

1. The date on which the NQDCP first provides that assets will become restricted to the provision of benefits under the plan, in connection with a change in the employer's financial health; or

2. The date on which assets *are* so restricted, regardless of whether the assets are available to the employer's general creditors.

NONQUALIFIED DEFERRED COMPENSATION PLAN

"Nonqualified deferred compensation plan" means *any* plan that provides for the deferral of compensation (including nonelective deferred compensation), other than:

- A qualified plan;
- A 403(a) or (b) plan;
- A SEP or SIMPLE Plan;
- A section 501(c)(18) trust;
- A section 457(b) eligible deferred compensation plan. The changes *will* apply to ineligible 457 plans (457(f) plans) and to arrangements that are not subject to section 457, either because the employer is not subject to section 457 (e.g., a church) or because the particular plan is excluded from section 457;
- A qualified governmental excess benefit plan (section 415(m)); and
- Any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan.

"Plan" includes any agreement or arrangement, including one that covers only one person. Section 409A is not limited to employer-employee arrangements. The proposed regulations generally retain the plan aggregation rules set forth in Notice 2005-1, Q&A-9.

The new rules are not intended to change the taxation of (1) the grant of an option on employer stock with an exercise price that is not less than the fair market value of the stock on the date of grant, if there are no additional deferral features; (2) incentive stock options (section 422); (3) options granted under an employee stock purchase plan (section 423); or (4) annual bonuses or similar amounts paid within 2 1/2 months after the close of the year in which the relevant services are performed.

In response to comments, the proposed regulations treat stock appreciation rights (SARs) similarly to stock options, regardless of whether the SAR is (1) settled in cash and/or (2) based upon service recipient stock that is not readily tradable on an established securities market.

The proposed regulations do not address arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7.

Because short-term payments upon an involuntary separation from service are common, and compliance with section 409A may be burdensome, the proposed regulations generally exempt such arrangements. The scope of the exemption is consistent with the safe harbor under which severance plans may be treated as welfare plans under the Department of Labor's ERISA regulations.

Split-dollar life insurance arrangements that provide only death benefits to or for the benefit of the service recipient may be excluded from coverage under section 409A under the exception for death benefit plans. Also, split-dollar arrangements treated as loan arrangements generally will not be subject to section 409A, if there is no agreement to forgive the debt and no obligation on the part of the service recipient to pay premiums without charging a market interest rate. However, policies structured under the endorsement method may be covered.

SUBSTANTIAL RISK OF FORFEITURE

There is a substantial risk of forfeiture if the rights to compensation are conditioned upon the future performance of substantial services by any individual. This appears to be narrower than the definition of this term for purposes of other provisions, such as sections 83 or 457, but is the same as under Notice 2005-1, Q&A-10. Certain amendments of an arrangement to extend a substantial risk of forfeiture will not be recognized.

EARNINGS

References to deferred compensation include references to income on that compensation. "Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the Act." General Explanation, at 476.

REPORTING DEFERRED AMOUNTS

In the case of an employee, the Act generally requires deferrals under a NQDCP to be reported on Form W-2. Regulations may establish a minimum amount below which this requirement does not apply. For purposes of income tax withholding, section 3401(a) (defining wages) is amended to include any amount includible in gross income of an employee under section 409A.

In the case of non-employees, the Act amends section 6041 so that most deferrals will be reportable on Form 1099.

EFFECTIVE DATES AND TRANSITION RELIEF

The statutory changes generally apply to amounts deferred after December 31, 2004. The changes apply to earnings on deferred compensation only to the extent that they apply to the deferred compensation itself.

An amount is considered deferred before January 1, 2005, only if the amount is *earned and vested* before that date. To the extent that there is no material modification of the plan after October 3, 2004, prior law applies to such vested amounts.

Amounts deferred in taxable years beginning before January 1, 2005, will be treated as deferred in a taxable year beginning on or after that date if the plan is *materially modified* after October 3, 2004, unless the modification is pursuant to guidance described in the statute. (See Notice 2005-1, Q & A 16, 18, 20). To avoid the potentially disastrous consequences of an inadvertent modification, the proposed regulations allow a material modification to be rescinded to preserve a plan's grandfathered status.

The provisions relating to offshore trusts and financial triggers are effective January 1, 2005. General Explanation, at 478. Subject to this exception, Notice 2005-1, Q&A-19, provides that a plan adopted on or before December 31, 2005, will not be treated as violating section 409A if the plan (1) is operated in good faith compliance with the provisions of section 409A and Notice 2005-1 during 2005, and (2) is amended by December 31, 2005, to conform to the requirements of section 409A. The proposed regulations extend the good faith compliance period and the amendment deadline to December 31, 2006. Compliance with the proposed regulations will be good faith compliance with the statute.

Notice 2005-1, Q&A-19(c) provided generally that a plan could be amended to provide for new payment elections without violating the subsequent deferral and anti-acceleration rules, provided that the plan was amended and the participant made the election on or before December 31, 2005. The proposed regulations extend this period through December 31, 2006, except that a service provider cannot in 2006 change payment elections with respect to payments that the service provider would otherwise receive in 2006, or to cause payments to be made in 2006.

Notice 2005-1 Q&A-23 provides that an election under a NQDCP that is controlled by an election under a qualified plan can continue in effect throughout 2005. Commentators requested that this relief be permanent but the proposed regulations only extend the relief through calendar year 2006.

Notice 2005-1, Q&A-21 generally permitted initial deferral elections with respect to services performed on or before December 31, 2005, to be made on or before March 15, 2005. This relief has not been extended.

Notice 2005-1, Q&A-20 permits a plan adopted before December 31, 2005, to give a participant a right to terminate participation in the plan, or cancel an outstanding deferral election. Any necessary plan amendment must be adopted and effective on or before December 31, 2005, and the amount subject to the termination or cancellation must be includible in income of the participant in 2005 or, if later, in the taxable year in which the amounts are earned and vested. This period has not been extended.

Notice 2005-1, Q&A-18(c) provides that amending an arrangement on or before December 31, 2005, to terminate the arrangement and distribute the amounts deferred will not be treated as a material modification, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs. This relief has not been extended.

WHAT SHOULD EMPLOYERS DO NOW?

Any employer that has not already done so should immediately begin to catalog all programs or arrangements for employees and contractors that are or may be subject to section 409A. This may include programs that are not usually viewed as being NQDCPs, e.g., provisions of an executive employment agreement. The employer must then identify the changes that are required, communicate the changes to those affected, renegotiate contracts (if necessary) and adopt the necessary plan amendments. For a helpful guide, see Ethan Lipsig, *How Does Section 409A Affect My Company? A Self-Diagnostic Guide for Employers*, 32 BNA Pension & Benefits Reporter 1330 (June 14, 2005).

Participants must also act quickly. For instance, a participant who wishes to cancel a deferral or terminate plan participation must act by December 31, 2005, as must one who wishes to make or change a deferral election with respect to 2006 compensation or cause payments to be made in 2006. A grandfathered plan may be terminated by December 31, 2005 without the termination being treated as a material modification.