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THE NEW DEFERRED COMPENSATION RULES: WHAT EMPLOYERS MOST NEED TO KNOW

Most nonqualified deferred compensation arrangements (NQDCAs) have been subject to new, and in some respects radically different, rules since January 1, 2005. The new rules restrict: (1) elections to defer compensation; (2) benefit payment elections; and (3) the timing of distributions. These new restrictions require modifications – some subtle and others significant – to many existing NQDCAs, and will alter the design of new NQDCAs.

The Internal Revenue Service finally provided useful guidance for employers trying to comply with the new rules, in the form of proposed regulations under Section 409A of the Internal Revenue Code, on September 29, 2005.* The proposed regulations are lengthy and complex. They provide extensive details for distinguishing what's covered by Section 409A from what's not, and determining how to comply with the new restrictions. This *Viewpoint* summarizes the key provisions.

Employers that sponsor NQDCAs must operate them in good faith compliance with the proposed regulations or with Notice 2005-1 (the initial IRS guidance under Section 409A) in 2005 and 2006. Compliance amendments generally must be adopted by **December 31, 2006** (with certain exceptions noted in the italicized paragraphs under "Key Changes," below). Failure to comply operationally or in form will result in immediate income tax and a 20% penalty tax on NQDCA participants, as well as interest on any resulting underpayment of tax.

WHAT'S COVERED BY SECTION 409A AND WHAT'S NOT

Section 409A covers amounts deferred or vested under any NQDCA after 2004, *unless* the NQDCA is expressly excluded from Section 409A coverage. Section 409A also applies to amounts deferred under any covered NQDCA that is, or has been, materially modified after October 3, 2004, regardless of the timing of the deferral.

A covered NQDCA can take the form of a plan or policy covering one or more employees, or provisions of an individual agreement with a single employee. An NQDCA is any arrangement pursuant to which an employee earns a legally binding right during one tax year to be paid in a later year. This is true even if the promise is subject to conditions, such as continued employment, involuntary termination of employment, or the employer's achievement of specific goals.

* NQDCAs that are subject to Section 409A are not limited to employer-sponsored plans. For example, they may involve corporations and one or more directors or trustees, partnerships and their partners, and any person or entity and an independent contractor who primarily performs services for that person or entity. They also may take the form of policies or individual arrangements. For convenience, this *Viewpoint* refers to employees and other service providers as employees, the entities sponsoring NQDCAs as employers, and NQDCAs as plans.

Statutory exclusions. Qualified and quasi-qualified plans (such as Section 403(b) tax-sheltered annuities and Section 457(b) plans) and many welfare plans, including *bona fide* vacation, sick leave, compensatory time, disability and death benefit plans, are not covered by Section 409A. The IRS has provided other critical coverage exemptions.

Short-term deferrals. The proposed regulations exempt from Section 409A coverage plans that pay benefits within 2½ months after the end of the employee's or the employer's tax year in which they vest (*i.e.*, become non-forfeitable). This exception applies to many short and long-term incentive plans and even some supplemental executive retirement plans (SERPs) that pay out all benefits immediately upon vesting. However, this exception does not apply to any plans that allow employees to elect to defer pay. As long as the payment date is stated in the plan document, the plan will not lose its Section 409A exemption just because payment is unexpectedly delayed due to unforeseeable events.

Separation pay arrangements. Some severance pay arrangements are subject to Section 409A. However, IRS rules exclude from Section 409A coverage payments made under certain separation pay arrangements: (1) for an involuntary separation or pursuant to a window program, severance paid over a limited period of time and in an amount that does not exceed IRS limits; (2) certain expense reimbursements; and (3) payments required under a collectively bargained plan.

Equity plans. The proposed regulations distinguish between Section 409A-covered and Section 409A-exempt equity-based plans. The following arrangements are exempt: incentive stock option (ISO) plans, qualified employee stock purchase plans, and nonqualified stock option and stock appreciation right (SAR) plans that involve employer stock and do not include a discount or post-exercise deferral feature. Section 409A covers all other nonqualified option and SAR grants.

Foreign plans. Foreign plans are exempt, but only if they meet certain conditions – for example, they are broad-based and established primarily for non-resident aliens or pay benefits that are excluded from tax by a U.S. tax treaty with a foreign government.

KEY CHANGES

Initial Deferral Elections. An employee may elect to defer payment for services to be performed during his or her tax year only by making an *irrevocable* election before the tax year begins. The key exceptions to this general rule apply to elections to defer: (1) any future compensation, if made within the first 30 days an employee is eligible to participate in an NQDCA or any NQDCA of the same type; (2) “performance-based compensation”; and (3) fiscal-year bonus pay. Special initial deferral rules apply to a number of other types of payment arrangements.

Under the proposed rules, benefit payment elections are considered deferrals. If an employer wants to give its employees the opportunity to elect how and when they will receive their NQDCA benefits, without onerous payment delays, the employer must permit benefit elections to be made in accordance with the timing requirements for initial deferral elections. This will be a major change in operation for many NQDCAs.

Special 2005 Deferral Election. If employees made new deferral elections by March 15, 2005, as permitted by Notice 2005-1, this must be reflected in a plan amendment adopted by December 31, 2005.

Cancellation of Deferrals in 2005. An employee may cancel one or more deferral elections, if his or her employer permits, or the employer may unilaterally cancel one or more employee deferrals if the plan permits. The cancellation must take place and be reflected in a plan amendment adopted by December 31, 2005.

Changes in the time and form of payment. If an employee wants to defer a scheduled payment, or change the scheduled form of payment, he or she may do so by making a deferral election at least 12 months before the first scheduled payment date. Moreover, the election must defer payment for *at least five* additional years from the first scheduled payment date. Few NQDCAs can comply with these restrictions without major modification.

Actually complying with these restrictions will be impractical for many NQDCAs. For example, suppose an NQDCA would pay a single life annuity at normal retirement age (65), unless an employee elects a lump sum, and an employee wants the lump sum. That employee would be required to elect, before his or her 64th birthday, to be paid the lump sum at age 70.

To permit employees to choose the lump sum, without requiring a five-year payment delay, the employer could permit them to make benefit distribution elections when they first become eligible to participate, in accordance with the initial deferral election rules. Many employers have already chosen this path to compliance.

An exception to the restrictions on changing the time and form of payment applies if the only change is from one type of life annuity to another actuarially equivalent life annuity (for example, single life to joint and survivor). So, if an employee wanted to elect a joint and survivor life annuity instead of a single life annuity at retirement, he or she could be permitted to do so shortly before retirement, with no payment delay. An employer with an NQDCA that only pays actuarially equivalent life annuities may be able to liberalize the NQDCA's current benefit election requirements.

Special distribution elections in 2005 and 2006. Under a special transitional rule, an NQDCA may be amended to permit NQDCA participants to make new benefit distribution elections **by December 31, 2006**, without suffering the five-year delay in payment Section 409A generally imposes on benefit election changes. This special transition rule cannot be used in 2006 to delay a payment that would otherwise be paid, or begin to be paid, in 2006, nor can it be used to accelerate a payment into 2006.

Distribution restrictions. In general, an NQDCA may not distribute benefits except upon the occurrence of one or more of the following: (1) separation from service; (2) total and permanent disability; (3) death; (4) a time (or pursuant to a fixed schedule) specified at the time of deferral, including a time or schedule contingent on the occurrence of a specified vesting event; (5) a change in control of the employer; or (6) the occurrence of an unforeseeable emergency. The proposed regulations carefully define these events to eliminate the ability to manipulate the timing of payments.

An NQDCA meets the distribution requirements only if it provides for a payment date or schedule that is objectively determinable when the specified event occurs (for example, first day of the month following termination of employment). The NQDCA may provide alternate payment dates or schedules based upon the event resulting in distribution.

Many NQDCAs do not meet all of the distribution restrictions described above, at least in a few respects. Therefore, employers should carefully review distribution provisions for good-faith operational compliance with Section 409A before making distributions.

An additional restriction applies to distributions to key employees of public companies on account of separation from service. Such distributions may not be made until six months after separation from service. This restriction will require changes to most public company NQDCAs, including some severance pay arrangements that cover key employees. The proposed regulations contain special rules for identifying key employees.

Anti-acceleration restrictions. Distributions from an NQDCA may not be made before the payment date specified by the employer or initially elected by the employee, except under very limited circumstances prescribed by regulation. Distributions made solely on account of plan termination generally violate the anti-acceleration provision. However, the proposed regulations permit distributions upon termination in three limited circumstances: (1) bankruptcy or liquidation of the employer; (2) change in control of the employer; or (3) if the employer maintains no other NQDCA of a similar type *and* does not establish a new NQDCA of the same type within five years of termination.

Plan terminations in 2005. *An employer may terminate an NQDCA, and distribute benefits under the terminated NQDCA, on or before December 31, 2005. This special rule should be used with any NQDCA an employer does not want to maintain, including one under which all amounts were deferred and vested before 2005. Plan termination amendments must be adopted and executed by the end of 2005.*

NEW REPORTING RULES

Starting with the 2005 tax year, Section 409A requires employers to report on Form W-2 or Form 1099 all deferred compensation amounts, even if such amounts are not included in income. The IRS is considering some kind of relief from this requirement for reports due by January 31, 2006.

For more information on the impact of Section 409A and the proposed regulations on deferred compensation plans, please contact your Hay Consultant or Melissa Rasman (215-861-2350 or Melissa_Rasman@haygroup.com).

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