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LEGAL TOPICS

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DEFERRED COMPENSATION - WHAT YOU DON'T KNOW CAN HURT YOU

Proposed regulations have just been issued explaining the requirements of a new law governing deferred compensation plans. In October, 2004, the new law made major changes to the rules applying to many compensation arrangements, including deferred compensation plans, employment contracts, equity arrangements, and even individual agreements by creating a new Internal Revenue Code Section 409A ("Section 409A"). On December 20, 2004, the IRS issued initial guidance interpreting Section 409A in Notice 2005-1, but many issues remained unclear. On September 29, 2005, the IRS issued proposed regulations (the "Proposed Regulations") and filled in some of the gaps.

Important points:

⇒ Most current plans (non-qualified, retirement plans or agreements) must be amended.

⇒ Individual agreements must comply.

⇒ Many employment agreements providing severance pay and severance agreements will qualify for an exception.

⇒ Bonus and compensation arrangements that are subject to Section 409A must be in writing.

⇒ The consequences of failing to act can be financially disastrous for participants.

Section 409A – Does it affect you or your company?

Does your company utilize any of the compensation arrangements listed below for employees, directors or independent contractors (referred to as "employees" in the remainder of this article)? Do you have an employment contract that provides for severance pay and/or continued benefits following termination? If so, the arrangements should be reviewed to determine what steps, if any, need to be taken to become Section 409A compliant.

- Deferred Compensation Agreements
- Salary Continuation Agreements
- Supplemental Executive Retirement Agreements ("SERP")
- Bonus Plans
- Incentive Pay Plans
- Excess Benefit Plans
- 401(k) Wrap Plans
- Employment Contracts Providing Severance Benefits
- Separation Pay/Severance Agreements
- Change in Control Separation Agreements
- Stock Option Plans and Agreements
- Stock Appreciation Rights Plans and Agreements
- Phantom Stock Arrangements
- Split Dollar Life Insurance Agreements

Section 409A defines deferred compensation as any compensation where (1) the employee obtains a legally binding right to compensation during a year, and (2)

the compensation is paid in a later year. Thus, Section 409A now regulates many compensation arrangements that were previously unregulated.

Important dates and deadlines

January 1, 2005: Effective date of Section 409A. This deadline was not extended by the Proposed Regulations, and all compensation arrangements subject to Section 409A must be operated in "good faith" compliance with Section 409A after January 1, 2005.

December 31, 2005:

- latest date for plan participants to terminate participation in a plan or to cancel an outstanding deferral election
- latest date for grandfathered plans to be terminated (and compensation paid as income) without termination causing plan to be subject to Section 409A
- latest date for plan participants to make deferral elections for 2006 compensation
- amounts deferred in account balance plans during 2005 must be reported on W-2 or 1099 forms when issued

December 31, 2006: Latest date for plan documents and agreements to be amended to comply with Section 409A. This deadline was extended for an additional one year period (prior deadline was December 31, 2005).

January 1, 2007: Earliest possible effective date of final regulations. Between now and the issuance of final regulations, taxpayers are entitled to rely upon the Proposed Regulations for good faith compliance with Section 409A.

How does Section 409A work?

Section 409A requires both operational and documentary compliance. For the first time, deferred compensation arrangements must be set forth in a written document that complies with Section 409A. If a plan fails to meet the requirements of Section 409A (whether the failure is in the terms of the plan document or occurs by operation of the plan), the result is immediate taxation on the participant.

What are the adverse consequences to the participant?

If a deferred compensation arrangement fails to comply with Section 409A, all compensation deferred under the plan for the taxable year and for all previous taxable years will be includible in the plan participant's gross income for the current taxable year. In addition, past interest and an additional 20% tax will be imposed. Also, under the plan aggregation rule, all similar plans in which the participant receives deferred compensation will be deemed out of compliance and taxed as well.

What does Section 409A require?

Section 409A contains detailed requirements governing distributions, acceleration of benefits, timing of deferral elections, timing or form of payment elections, funding, and financial health triggers. This alert summarizes the principal requirements in the following sections.

Distribution restrictions

Section 409A limits the types of events that can trigger a distribution from a plan to (1) separation from service; (2) disability; (3) death; (4) as necessary to meet an "unforeseeable emergency"; (5) a time specified (or pursuant to a fixed schedule) under the plan at the date of the deferral; and (6) a change in ownership or effective control of a corporation (or, by analogy, of a partnership). Each of these events has been narrowly defined by the Proposed Regulations, and plan documents must be drafted in accordance with the Section 409A definitions. For "key employees" of publicly traded corporations, distributions due to separation from service may not be made earlier than 6 months following the separation from service. Publicly traded corporations include corporations whose stock is readily tradable on an "over-the-counter" market.

Acceleration of benefits

Plans may not permit acceleration of the time or schedule of any payment under the plans, except as provided in regulations. Common provisions allowing an early distribution with a small "haircut" are now prohibited.

Timing of deferral elections

Deferral elections generally must be made no later than the close of the year prior to the year during which the

services giving rise to the compensation are performed. However, there are some exceptions.

- Initial Eligibility. When a participant first becomes eligible to participate in the plan, the election to defer may be made within 30 days following the date the participant becomes eligible, but the election applies only to compensation earned after the election.

- Evergreen Deferral Elections. If a plan utilizes an "evergreen" election form which provides that it is effective until revoked, the election form must provide that the election becomes irrevocable for a future calendar year no later than the December 31 of the preceding calendar year.

- Performance-based compensation. When compensation is based on established performance criteria and is earned over a period of at least 12 months, elections may be made up to six months before the end of the performance period (on or before July 1 for calendar years).

Timing or form of payments

If a plan allows an employee to elect the time or form of payment, this election must be made prior to the last day of the employee's tax year prior to the year in which the first services are performed. If a plan does not allow for the employee to elect the time or form of payment, then the time and form of payment should be set forth in the plan document prior to the first services being performed.

Changes in timing or form of payments

Plans can allow a participant to make a subsequent election to delay or change the form of payment. However, subsequent elections may not take effect until 12 months after the date of the election. Further, in the case of distributions for events other than disability, death, or unforeseeable emergency, the first payment cannot take effect until at least 5 years from the date the payment would otherwise have been made.

Funding

In most instances, if assets are set aside in an offshore trust (even if a "rabbi trust" is used), the assets are treated as Internal Revenue Code Section 83 "property" and are taxable when set aside.

Financial health triggers

If an arrangement attempts to restrict assets to providing nonqualified deferred compensation benefits in connection with a change in an employer's financial health will result in immediate taxation, regardless of whether the assets remain subject to the claims of the employer's creditors.

Reporting requirements

Employers who sponsor plans subject to Section 409A must report the amounts of deferrals on W-2 (employee) and 1099 (independent contractor) forms. For account balance plans (where compensation is deferred), the annual amounts deferred must be reported beginning in 2005. For plans which provide defined benefits at retirement (nonaccount balance plans), the IRS has not yet issued regulations providing how to calculate the amount of deferrals to report on W-2 and 1099 forms each year. Employers are not required to report on these types of plans until additional regulations are issued.

Equity-Based compensation

Stock options and stock appreciation rights may be subject to Section 409A. Section 409A generally will not apply if either (i) the exercise price is not less than the underlying stock's fair market value on the date of grant and certain other conditions are met or (ii) exercise is limited to the "short-term deferral period" beginning on the date the option or right vests and ending on the later of the 15th day of the third month following the employee's taxable year in which the option or right vests or the 15th day of the third month following the employer's taxable year in which the option or right vests. In addition, Section 409A generally does not apply to an option qualifying as an incentive stock option under Section 422 or an option issued under an employee stock purchase plan under Section 423.

Exceptions to Section 409A

There are some exceptions to the application of Section 409A provided in the Act as well as in the Proposed Regulations. These include: short-term deferrals (where

payments are made by the later of the 15th day of the third month following the employee's taxable year in which the payment right vests or the 15th day of the third month following the employer's taxable year in which the payment right vests), some severance pay and early retirement incentive programs providing for limited payments during limited time periods, some stock options and stock appreciation rights plans as mentioned above, and certain split dollar agreements. Determining whether an exception applies will depend upon the proper application of Section 409A and the Proposed Regulations to the specific facts.

Practical considerations

The IRS has informally confirmed the experience of our attorneys since the enactment of Section 409A that some amendment will be required in order for most existing plans to become compliant with Section 409A. It might be as simple as having to change the definition of "disability." But the failure to make the change would be disastrous.

If your company sponsors one or more of the plans or arrangements listed at the outset of this legal alert, or if you are a participant in such a plan, we advise that you consult with qualified legal counsel for advice on how to achieve compliance with Section 409A. ■

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