



Electronic Dispatch

Employee Benefits Law Action Memo

November 2005

[Go to BS&K Employee Benefits Home Page](#)

ACTIONS REQUIRED IN 2005 UNDER THE NEW PROPOSED REGULATIONS FOR NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

New proposed regulations for “nonqualified deferred compensation plans” were issued by the Internal Revenue Service (“IRS”) on September 29, 2005 (“Proposed Regulations”). The Proposed Regulations are both lengthy (238 pages) and complicated, but also provide helpful transition rules and exceptions that will be very beneficial to many employers. Among the more helpful transition rules is an extension of the deadline to amend many nonqualified deferred compensation plans to comply with the new requirements from December 31, 2005 to December 31, 2006, as long as the plans are operated in good faith compliance with the new requirements through December 31, 2006. However, there are certain actions that must still be taken by December 31, 2005, if adverse tax consequences are to be avoided with respect to certain nonqualified deferred compensation plans. Employers should review all such plans in order to determine if any action by the end of the year will be required.

Relationship To Prior Guidance

The new requirements for nonqualified deferred compensation plans were added to the Internal Revenue Code (“Code”) on October 22, 2004 in a new Section 409A (“New Requirements”), and are summarized in a *BS&K Employee Benefits Law Action Memo* dated October 2004. The statute broadly defines “nonqualified deferred compensation plans” to include many arrangements that typically had not been considered to be nonqualified deferred compensation, and imposed new deferral election, payment election, distribution, funding, and reporting requirements on those arrangements. Nonqualified deferred compensation amounts that are earned or become vested after December 31, 2004 generally must comply with the New Requirements. Failure to satisfy the New Requirements could result in substantial adverse tax consequences, including accelerated income tax payments, interest penalties, and an additional tax of 20 percent.

The IRS’ initial guidance regarding the New Requirements was issued in December of 2004 in Notice 2005-1, and is summarized in a *BS&K Employee Benefits Law Information Memo* dated January 2005. The Proposed Regulations are intended to be read in conjunction with Notice 2005-1, and are expected to be finalized prior to 2007. An employer is required to act in good faith compliance with the New Requirements prior to 2007, and may rely upon the applicable statutory provisions and Notice 2005-1 (and, if it wishes, the Proposed Regulations) as evidence that it has so acted.

Actions That Still Must Be Taken In 2005

Although the Proposed Regulations provide many helpful transition rules that delay the need to take certain actions until December 31, 2006, employers still will be required to take the following actions in 2005 for nonqualified deferred compensation amounts that are earned or become vested after December 31, 2004:

- Deferral Elections For Compensation Earned In 2006 (Other Than Certain Performance-Based Compensation) Must Be Made By December 31, 2005 – Nonqualified deferred compensation plans that allow participants to make voluntary elective deferrals of compensation generally must, under the New Requirements, ensure that such deferral elections are made prior to the end of the taxable year that precedes the year during which the compensation will be earned. The need to comply with this requirement has not been delayed by the Proposed Regulations,



which means that compensation to be earned in 2006 may be effectively deferred only if the deferral election is made by December 31, 2005. As an exception to the preceding two sentences, the New Requirements provide that an election to defer “performance-based” compensation may be made as late as six months prior to the end of the measuring period (e.g., a bonus that will be based upon performance during calendar year 2006 and will be paid in calendar year 2007 may be deferred as long as the deferral election is made by June 30, 2006).

- Elections As To the Time or Form of Payments That Are Owed or Payable In 2006 Must Be Made No Later Than December 31, 2005 – The New Requirements impose deadlines for electing the time or form of payments of nonqualified deferred compensation amounts, and on the ability to change those elections. Elections with respect to the time or form of payments of nonqualified deferred compensation amounts that are owed or payable in 2006 (including acceleration of the timing of a payment so that it is paid in 2006) must be made no later than December 31, 2005. In certain circumstances, the deadline in the preceding sentence could be earlier due to “constructive receipt” requirements under the Code. If an employee has yet to elect the time or form of a nonqualified deferred compensation payment that is owed or payable in 2006, or wishes to change the time and form of such a payment, an immediate analysis should be done to determine the options that are available to the employee. Special rules apply if an election of the time or form of a nonqualified deferred compensation payment is linked to a payment election under a qualified retirement plan.
- The Deadline For Canceling Elections or Terminating Plan Participation Continues To Be December 31, 2005 – IRS Notice 2005-1 provides special transition rules that allow certain nonqualified deferred compensation plans to give participants a chance to cancel an outstanding deferral election under the plan or to terminate participation in the plan (and for a plan sponsor to make any applicable amendments). The deadline for such a cancellation or termination is December 31, 2005, and that deadline was not extended in the Proposed Regulations. Nonqualified deferred compensation amounts affected by such a cancellation or termination are required to be included in a participant’s income in 2005 (or, if later, the taxable year in which the amounts are earned and vested).
- Offering Cash To Help Replace Discounted Stock Options (“Options”) and Stock Appreciation Rights (“SARs”) With Non-Discounted Options and SARs Must Be Done By December 31, 2005 – Options and SARs that have been discounted generally will be treated as deferred compensation subject to the New Requirements. A special transition rule will allow employers, if they act by December 31, 2005, to both (1) replace discounted Options and SARs with non-discounted Options and SARs, and (2) make a cash payment to the applicable employee to help make up the value of the discount lost.

A special transition rule that allows “grandfathered” nonqualified deferred compensation plans to be terminated, and distributions to be made from those plans without losing “grandfather” status, also expires on December 31, 2005. A nonqualified deferred compensation plan will be “grandfathered” if, among other things, the amounts accrued under the plan were earned and vested by December 31, 2004, and no material modification has been made to the plan on or after October 3, 2004.

Steps That Should Be Taken By Employers

Employers have been required to act in good faith compliance with the New Requirements since January 1, 2005. To the extent they have not already done so, employers should:

- identify all nonqualified deferred compensation arrangements that are subject to the New Requirements (any plan, agreement, or arrangement that provides for a deferral of compensation for an employee, director, or independent contractor should be reviewed to see if the New Requirements apply, including certain employment contracts, severance pay plans, SARs, “phantom” stock plans, and any similar plan or arrangement);

- become familiar with the New Requirements, and make sure that all of the identified nonqualified deferred compensation arrangements are being operated in good faith compliance with the New Requirements; and
- prepare any documents with respect to the identified nonqualified deferred compensation arrangements that will be required in 2006 (including, but not limited to, any necessary amendments to such arrangements, and the applicable portions of IRS Forms W-2 and 1099 that will have to be completed as part of the new reporting requirements for vested and non-vested amounts earned under all nonqualified deferred compensation arrangements).

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