

## Deferred Compensation Under 409A: Action Items

The second round of long-awaited guidance addressing the application of new Internal Revenue Code § 409A (409A) to nonqualified deferred compensation has been issued in the form of proposed regulations. The comprehensive guidance generally provides workable rules for complying with 409A. As anticipated, many of the favorable transition rules provided in Notice 2005-1, which was issued in late December 2004, have been extended to the end of 2006, easing the pressure for most compliance issues. *However, the expiration of some transition rules in 2005 requires prompt attention for certain actions that must be taken before December 31, 2005.* This benefits alert identifies those actions that must be taken before the end of 2005 and offers an action plan for 2006. Highlights of selected issues from the proposed regulations are addressed in a separate release.

### Background: Code § 409A

Section 409A was enacted in October 2004, as part of the American Jobs Creation Act of 2004. The new law dramatically changed the rules governing nonqualified deferred compensation. Affecting a wide range of plans and arrangements, from individual employment agreements to phantom stock plans, 409A imposes significant new restrictions on deferrals, distributions, and changes in the timing of elections and in the form and time of payment of benefits. Penalties for noncompliance are steep (i.e., immediate taxation of all amounts, interest, and a 20% penalty tax), underscoring the need for careful attention to the new rules.

Initial guidance addressing the new law was issued in late December 2004, in the form of IRS Notice 2005-1. The proposed regulations generally continue and expand upon the rules set forth in the notice. The Employee Benefits Practice Group issued previous alerts in December 2004 and March 2005, summarizing the new law and Notice 2005-1.

### Effective dates

Section 409A generally became effective January 1, 2005, affecting all amounts that are not grandfathered under the old rules (e.g., amounts that were not earned and vested as of December 31, 2004). Although the proposed regulations are not scheduled to become effective until January 1, 2007, plans must be operated in good faith compliance with 409A in the interim. Plans may rely on Notice 2005-1 and the proposed regulations until final regulations become effective.

### Actions that must be completed by December 31, 2005

The table below identifies those actions that must be completed by December 31, 2005. In addition to routine solicitation of deferral elections and modification of employee communications, plan sponsors must decide if they wish to take advantage of any of the transition rules scheduled to expire in 2005—and, if so, take prompt action.

#### Actions with a December 31, 2005 deadline

- ▶ **Canceling deferrals and terminating participation in plan.** Plans may permit participants in 2005 to terminate their participation in a plan or to cancel all or a portion of their prior deferral elections. Under this transition rule, participants must include the compensation in income for 2005 and the plan must be amended by December 31, 2005. Employers need not grant the right to terminate participation or to revoke deferral elections to all participants.
- ▶ **Terminating plans.** A plan sponsor wishing to terminate an existing plan without meeting the 409A restrictions on plan termination (see below) must terminate the plan and distribute all amounts by the end of 2005.
- ▶ **Delayed 2005 deferral elections.** Under the original transition rules, the deadline for making initial 2005 deferral elections was extended to March 15, 2005. Plans that permitted 2005 deferral elections

*continued ...*

## Actions with a December 31, 2005 deadline (cont.)

under this transition rule must be amended to reflect this practice no later than December 31, 2005.

► **Payments for elimination of discounts on stock options.** Any cash payments to compensate participants for the elimination of discounts on options and stock appreciation rights (SARs) must be made and included in taxable income in 2005.

► **Changes affecting 2006 payments.** Any changes in the time and form of payment elections that would affect payments scheduled for 2006 must be made in 2005. Also, plans may not accelerate payments into 2006 unless the election to change the payments is made before the end of 2005.

► **Updating forms and communications.** Election forms and employee communications distributed in 2005 must be modified to reflect changes in rules and procedures.

► **2006 deferral elections.** Plan sponsors must ensure that participants make deferral elections for 2006 non-performance-based compensation by December 31, 2005.

► **Identify amounts deferred in 2005.** Prepare for new reporting requirements by identifying amounts of compensation deferred in 2005. All 2005 deferrals (plus earnings) must be reported on a Form W-2 (Box 12, Code "Y") or Form 1099-MISC (Box 15a), even if the amounts are not yet taxable. Amounts that become taxable because of noncompliance with 409A also must be reported.

- ◆ Other nonelective deferral arrangements
- ◆ Bonus arrangements (annual, performance-based, multi-year, and contingent signing bonuses)
- ◆ Severance plans and arrangements
- ◆ Individual employment agreements
- ◆ Directors deferred compensation or incentive plans
- ◆ Discounted stock option plans and stock options with additional deferral features
- ◆ Stock appreciation rights, phantom stock, and restricted stock unit plans
- ◆ Code §457(f) deferred compensation plans
- ◆ Split dollar life insurance (certain "endorsement" method arrangements may be affected)
- ◆ Deferral arrangements for independent contractors and consultants

► **Identify changes.** For each existing deferred compensation arrangement, identify what changes, if any, are required to bring it into compliance with 409A.

► **Preserve or abandon grandfathered status.** Identify grandfathered arrangements and amounts, and decide whether to preserve grandfathered status or bring the entire plan into compliance with 409A. To retain grandfathered status, put procedures in place to avoid inadvertently modifying the plan and thereby triggering 409A coverage.

► **Permit changes in time and form of payment.** If permitting participants to change time and form of payment elections, ensure that all election changes are made and plans amended by the end of 2006—the ability to make these changes expires December 31, 2006. Elections made in 2006 may not apply to payments that otherwise would have been made in 2006 or cause later payments to be accelerated into 2006.

► **Eliminate links to elections under qualified plans.** Existing plans with payments linked to elections under qualified plans may continue to operate with this feature only through December 31, 2006. During 2006, alternative payment structures must be designed for implementation by 2007. Plans must be amended by the end of 2006 to incorporate acceptable payment features.

► **Identify key employees.** For public companies, identify key employees that would be affected by the required six-month delay in payment on separation from service.

► **Consider design changes to meet an exception.** Consider alternative design options for noncompliant provisions (e.g., whether an existing plan can be modified to

## Action plan for 2006

Except for the action items listed above, plan sponsors generally have until December 31, 2006, to amend their plans to bring them into compliance with 409A. The following action plan may serve as a guide for 2006:

► **Identify plans and arrangements that may be affected.** Section 409A has a broad reach, affecting many types of plans and arrangements not historically thought of as deferred compensation. Employers need to identify and review the following arrangements to determine if any benefits payable under the arrangements fall within the 409A definition of deferred compensation:

- ◆ Supplemental executive retirement plans (SERPs), excess benefit plans, and mirror or wrap-around plans
- ◆ Other elective salary deferral arrangements

fit within the short-term deferral exception from coverage under 409A).

► **Establish performance criteria and solicit elections for performance-based awards.** For 2006 performance-based awards, establish performance criteria in writing within 90 days after the beginning of the performance period. Ensure that elections are made at least six months before the end of the performance period.

► **Address securities law issues.** For public companies, consider securities law issues, including reporting requirements, shareholder approval requirements, and corporate governance rules affected by 409A changes in plans and arrangements. Take appropriate action where necessary.

► **Substitute discounted stock options and SARs.** Stock options and SARs may be replaced with nondiscounted stock options and SARs that will qualify for exemption from 409A, so long as the replacement takes place by the end of 2006.

► **Comply with writing requirement.** Ensure that the material terms of all deferred compensation arrangements are set forth in writing to meet the new 409A writing requirement. Material terms include the amount deferred under the arrangement and the time and form of payment.

► **Comply with new reporting requirements.** Report on Forms W-2 or 1099-MISC all 2005 deferrals and earnings (see above). Report any amounts that become taxable because of noncompliance with 409A.

► **Amend documents.** Amend all plan documents by December 31, 2006 to bring plans into compliance with 409A or to convert plans into arrangements not subject to 409A.

If you have any questions about the impact of 409A on your deferred compensation plans or arrangements, please call your usual contact at Hodgson Russ, or contact any member of the Employee Benefits Practice Group.

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