NONQUALIFIED DEFERRED COMPENSATION: THE EFFECT OF THE NEW RULES NOW AND IN THE FUTURE

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I. Introduction

On October 22, 2004, President George W. Bush signed the American Jobs Creation Act of 2004, P.L. 108-357 (the Act). Among other changes, the Act provides for a new section of the Internal Revenue Code of 1986 (the code), section 409A. That section provides dramatic changes in the tax rules applicable to “nonqualified deferred compensation.”

During 2005 employers should consider what the changes in tax treatment will mean for their current nonqualified deferred compensation arrangements, and how those changes will affect their compensation programs in the future. In doing so, employers must take into account myriad other factors driving reconsideration of executive compensation programs. Other tax-related issues include increased IRS scrutiny of compensation provided to top officers of both taxable and tax-exempt entities, and the need to implement new reporting and withholding obligations during 2005. Outside the tax arena, there is the issuance of Financial Accounting Standards Board Statement 123(R), which will require companies to recognize compensation expense for the fair value of share-based compensation. Employers will also face increased pressure from shareholder groups regarding executive compensation.

This report is intended to help readers understand the new law, the guidance that Treasury and the IRS have issued so far, what questions remain and, most importantly, what considerations and actions employers should be taking to ensure that their compensation programs remain effective and competitive, while complying with the new income tax requirements.

II. Section 409A: Overview

Section 409A provides that amounts deferred under a “nonqualified deferred compensation plan” are included in income when deferred, or when the amounts are no longer subject to a substantial risk of forfeiture, if later, unless the nonqualified deferred compensation plan complies with requirements regarding timing of elections, distributions, and funding. If a plan fails to comply with the requirements of section 409A for a participant, then all amounts deferred by the participant are included in income in the year in which the amounts are deferred, or, if later, when no longer subject to a substantial risk of forfeiture. Also, section 409A provides for an additional tax of 20 percent of the includable amount plus interest at the underpayment rate plus 1 percent from the time the...
amount was first deferred, or when no longer subject to a substantial risk of forfeiture, if later, to the time the amount is included in income.

Section 409A adds to the existing body of law governing nonqualified deferred compensation. Prior law regarding the transfers of property in connection with performance of services under section 83 and the timing of income based on actual or constructive receipt under section 451 continues to apply as well. Also, the timing and amount of deductions associated with nonqualified deferred compensation, governed by sections 83, 162, and 404(a)(5), have not been changed by section 409A.

The new rules under section 409A are effective for deferrals of compensation after December 31, 2004. Deferrals earned and vested before 2005 remain subject only to prior law, except that amounts deferred under a plan that is materially modified after October 3, 2004, are treated as post-effective-date deferrals subject to section 409A.

On December 20, 2004, Treasury and the IRS issued Notice 2005-1, 2005-2 IRB 1, a revised version of which was issued on January 5, 2004 (Doc 2005-435, 2005 TNT 4-7) (the Notice). The Notice, the first of several items of guidance expected over the next few months, provides information on the definition of “nonqualified deferred compensation plan” for purposes of section 409A, determining amounts that are grandfathered and amounts that are subject to the new law, transition relief during 2005, and other specific issues such as the definition of a change in control.

III. What Is Subject to Section 409A?

A. Definition of ‘Deferred Compensation’

Because section 409A applies to “nonqualified deferred compensation plans,” the meaning of that term is critical to understanding the application of the new rules. The statutory definition provides that a nonqualified deferred compensation plan is any arrangement that provides for a deferral of compensation (unless it is otherwise excepted).

Notice 2005-1 provides guidance on the definition of the term “nonqualified deferred compensation” for purposes of section 409A. The approach taken by the Notice is to first establish a very broad definition of deferred compensation but then to provide several significant exceptions. Only those arrangements that provide an employee with a vested right to compensation in one year but income inclusion for tax purposes in a later year are considered as providing deferred compensation for purposes of section 409A. There are exceptions for arrangements that allow vesting in one year and payment in another, including short-term deferrals and some employer stock options and stock appreciation rights.

The result is that many common compensation arrangements, including those that cover multiple years, are not considered nonqualified deferred compensation plans for purposes of section 409A.

1. General rule. The general rule provides that a nonqualified deferred compensation plan is any plan in which there is a “legally binding right” to compensation in one year but the compensation is actually or constructively received in a later year. Whether a plan provides for a legally binding right is based on whether the amount of compensation is determined, as in an account balance, or determinable, as under a formula, at the end of the year. It is important to note that an employee can have a legally binding right even if the amount is not yet vested. While the ability of an employer to exercise discretion to reduce the amount payable would typically not result in a legally binding right, this fact is not taken into account if it is unlikely to be exercised.

Although the Notice adopts this broad general rule, it also provides for significant exceptions that effectively set the true scope of section 409A.

2. Short-term deferrals. If a plan requires that amounts are paid within a short period after the amount is fully earned and vested, the plan is not a nonqualified deferred compensation plan for purposes of section 409A. The exception covers any plan under which compensation is required to be, and is, paid within 2½ months of the end of the year in which the amounts become vested. The 2½ month period is measured from the end of the employee’s tax year or the end of the employer’s tax year, whichever is later. Thus, multiyear long-term bonus or incentive plans would not be deferred compensation as long as the plan requires payment, and amounts are paid, within the applicable 2½-month period after vesting. That exception does not apply if the employee has a choice regarding the timing of inclusion.

There is also a separate exception for customary payments if a payroll period crosses tax years.

3. Stock options, stock appreciation rights, and other equity-based compensation. In general, stock options, stock appreciation rights (SARs), and other equity-based compensation arrangements (that is, those that provide for appreciation over the value of equity at the time of grant) constitute nonqualified deferred compensation. The Notice provides exceptions for stock options and SARs. The exceptions outlined below apply to stock of a corporation. The Notice also provides that, until further guidance, the same principles apply to the compensatory transfer of a partnership interest or an option to purchase a partnership interest.

a. Stock options. Options to purchase stock of the employer (or other service recipient) are not nonqualified deferred compensation if the exercise price under the option cannot be less than the fair market value of the stock at the date of grant. For that purpose, an employer can use any reasonable valuation method. Also, the tax treatment of the option must be otherwise governed by section 83, and the option cannot provide for deferral of income other than through the ability to exercise during the option term.

Statutory stock options, incentive stock options, or options granted under an employer stock purchase plan (ESPP), including ESPP options that are granted with a...
b. Stock appreciation rights. The Notice provides two exceptions regarding SARs.

First, a SAR is not nonqualified deferred compensation if (1) it is granted on stock of the employer that is traded on an established securities market, (2) the SAR provides only for the transfer of stock on exercise, (3) the SAR exercise price can never be less than the fair market value of the stock at the original grant date, and (4) the SAR does not provide for deferral of income other than through the ability to exercise during the term of the SAR. The SAR must not be coupled with any arrangement under which the employer will purchase the stock received on exercise of the SAR.

Second, until further guidance, a SAR granted under a program in existence on October 3, 2004, will not be considered nonqualified deferred compensation if the SAR provides only for appreciation above fair market value of the stock at grant and does not provide for deferral of income other than through the ability to exercise during the term of the SAR. That exception applies without regard to whether the SAR is settled in stock or cash or is issued on public or private stock.

As with stock options, the SAR payment must be set by reference to the value of stock at the date of grant, an amount that may be determined using any reasonable valuation method. The general definition of “service recipient” also applies.

4. Restricted property. A transfer of property subject to section 83 does not result in deferred compensation solely because no amount is included in income until the property is no longer subject to a substantial risk of forfeiture or is transferable, or if an election is made under section 83(b). That exception applies only to transfers of restricted property, not to an unfunded, unsecured...
### Observations

The exceptions for equity-based compensation do not provide full detail on each specific requirement. Pending further guidance, taxpayers should operate under a reasonable, good-faith interpretation of Notice 2005-1 and section 409A. The following are some of the open issues employers should consider:

- **Reasonable valuation methods.** The Notice doesn’t provide additional guidance, except by reference to valuation methods permissible under the estate tax regulations. As a general matter, whether a method is reasonable is determined on the facts and circumstances, taking into account such factors as independent valuations and recent sales or purchases of stock from third parties.

- **Features that provide for deferral of compensation.** The exceptions for stock options and SARs are the only means by which a grant can allow for exercise after vesting and avoid classification as nonqualified deferred compensation. It would seem that an impermissible deferral feature is one that would combine option exercisability with an ability for the employee to elect further deferral after exercise. The Notice does provide that a SAR with a fixed payment date generally will comply with section 409A. Also, an arrangement that provides for fixed distribution dates that otherwise comply with section 409A would not fail to satisfy section 409A merely because the payment provides a rate of return linked to appreciation on stock.

- **Relationship between the general exception for short-term deferrals and options, SARs, and equity-based compensation.** The exception for short-term deferrals is separate from the exception for equity-based compensation. An arrangement that complies with either exception is not considered nonqualified deferred compensation. For example, a bonus arrangement that requires distributions within the time frame allowed by the short-term deferral exception would not be considered nonqualified deferred compensation even if the amount of the bonus is linked to appreciation in the stock of the service recipient.

### Observations

The exception for stock options allows for option exchanges in connection with a corporate transaction in accordance with the rules applicable to statutory stock options under section 424. In addition to mergers and acquisitions, these conversion rules also apply to stock dividends, stock splits, and distributions other than ordinary dividends. While employers have had more flexibility in converting nonqualified options to stock of an acquirer in the past, the ability to use the section 424 rules enables converted options to avoid the rules.

Although the section 424 rules do not apply to options issued to directors, options on partnership interest, or SARs, it would seem a reasonable interpretation of the Notice to use the section 424 rules for conversion of these grants. The section 424 regulatory rules do not apply to these grants because they cannot be statutory options.

would not otherwise be includable in income, Archer medical savings accounts, and health savings accounts under section 223.

### Observations

The approach taken in the Notice (for example, setting forth a general definition that is very broad but then providing for exceptions) is one that allows Treasury and the IRS a great deal of flexibility on an ongoing basis to regulate arrangements that might otherwise fall under an exception but are considered abusive.

### B. Other Important Definitions

In addition to guidance on the basic question of when an arrangement provides for “deferral of compensation” for purposes of section 409A, Notice 2005-1 also provides guidance on the application of several other important concepts.

1. **Service provider.** The Notice limits the scope of “service provider” to (1) an individual, (2) a personal service corporation as defined in section 269A(b)(1), or an entity that would be a personal service corporation if it were a corporation, or (3) a qualified personal service corporation as defined in section 448(d)(2), or an entity that would be a qualified personal service corporation if it were a corporation.

A personal service corporation (defined under section 269A(b)(1)) is a corporation whose principal activity is the rendering of personal services by employee owners. A qualified personal service corporation (defined under...
section 448(d)(2))) is an entity performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, the performing arts, or consulting in which substantially all of the stock is held directly or indirectly by the employees performing services for that corporation.

“Service provider” does not, however, include a service provider actively engaged in the trade or business of providing substantial services, other than as an employee or director, if that service provider provides services to two or more unrelated service recipients.

Also, the Notice limits the application of section 409A so that it does not apply to arrangements between taxpayers, each of which uses the accrual basis method of accounting.

2. Service recipient. The identification of the “service recipient” is important for identifying the parties to a deferred compensation arrangement and the employers for excepted stock options and SARs.

The definition of service recipient is based on the definition for qualified plan purposes, and references the person for whom services are performed, as well as other corporations considered a single employer under section 414(b) and other persons considered under common control for purposes of section 414(c). Generally speaking, those rules require ownership levels of 80 percent or higher, either through a parent-subsidiary chain or through ownership consolidated in five or fewer individuals.

3. Plan. A “plan” may cover only a single individual (that is, as part of an executive’s employment agreement), may cover independent contractors as well as common-law employees, and does not have to be in writing (although failure to be in writing may result in failure to comply with some requirements of section 409A).

Without regard to the structure of the arrangement, the Notice provides that section 409A is applied as if separate plans are maintained for each service provider. Also, separate arrangements maintained for the same service provider by a service recipient are considered a single plan to the extent that the arrangements are considered nonaccount balance plans, account balance plans, or other plans (including options, SARs, and equity-based compensation plans). Under that rule, an individual will be treated as having no more than three nonqualified deferred compensation plans subject to the new rules. That is primarily important for calculation of tax in the event a plan doesn’t comply.

Under section 409A, if there is a failure regarding a nonqualified deferred compensation plan, all amounts deferred by the participant under that plan are included in income. As a result of the definition in Notice 2005-1, a failure regarding an account balance plan, for example, will result in inclusion in income of all amounts under the particular account balance plan for which the failure occurred and all amounts deferred under any other account balance plan, to which section 409A applies, maintained by the service recipient for the same service provider. Amounts deferred under nonaccount balance plans or other plans not considered nonqualified deferred compensation account balance plans are not included in income.

The general rule of Notice 2005-1 that combines all arrangements for a service provider into no more than three plans is not applied for various purposes under the transition rules, as discussed below.

4. Substantial risk of forfeiture. Generally, a “substantial risk of forfeiture” requires that the receipt of deferred compensation be conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation. A condition must relate to the services provided, the service recipient’s business activities, or organizational goals.

That definition is similar to the definition of substantial risk of forfeiture applicable to transfers of property, such as restricted stock, under section 83. The Notice also provides further guidance on the meaning of substantial risk of forfeiture for purposes of section 409A. First, the Notice provides that a requirement to refrain from performance of services cannot be a substantial risk of forfeiture. Second, any addition or extension of a substantial risk of forfeiture after the beginning of the service period is not considered a substantial risk of forfeiture. An amount will not be subject to a substantial risk of forfeiture beyond the date it could otherwise be paid, unless the amount subject to the risk (other than earnings) is materially greater than the amount that would be
paid currently. Thus, an agreement to apply a substantial risk of forfeiture to salary deferrals is disregarded for purposes of section 409A, unless the amount paid under the deferred compensation arrangement (ignoring earnings) is potentially materially greater than the amount deferred.

C. Application to Specific Employers

1. Application to partnerships. A partnership can enter into nonqualified deferred compensation arrangements with its employees, and either as a service recipient or service provider. Notice 2005-1 provides that arrangements between a partner and a partnership that provide for deferral of compensation might be subject to section 409A. Pending further guidance, however, the Notice provides that issuance of profits interests, other partnership interests, and options on partnership interests are subject to the guidance provided in the Notice for equity-based compensation in general. Also, payments to retiring partners in liquidation of their partnership interest, other than some payments on account of retirement, are not subject to section 409A. Payments to a partner not in a partnership capacity are subject to section 409A if they otherwise constitute nonqualified deferred compensation.

2. Application to tax-exempt employers. Section 457(b) and section 403(b) plans sponsored by tax-exempt employers are not considered nonqualified deferred compensation plans.

A section 457(f) plan, however, is potentially subject to section 409A. Under section 457(f), deferred compensation is includable in income when it is no longer subject to a substantial risk of forfeiture. The definition of substantial risk of forfeiture for section 409A, discussed above, does not include an arrangement based on a noncompete agreement, that involves an addition of a substantial risk of forfeiture after the beginning of the service period, or that involves a risk of forfeiture regarding salary deferrals (unless an additional amount other than earnings is payable). Thus, some amounts deferred under a section 457(f) plan will be considered vested under section 409A before they are considered vested under section 457(f). As a result, the plan will not meet the short-term deferral exception to section 409A. It will therefore be required to comply with the requirements of both sections 409A and 457(f) if amounts are to avoid current taxation. For other 457(f) plans, all amounts deferred will be unvested until payment, in which case the plan will fall within the exception for short-term deferrals and will not be subject to the section 409A rules.

IV. Elections and Distributions

Section 409A provides specific requirements related to the timing of deferral elections and distributions, including a prohibition on acceleration of distributions. Notice 2005-1 does not provide comprehensive guidance for those requirements, but does address some items.

A. Timing of Elections

An elective deferral plan complies with the section 409A requirements only if an election to defer compensation for services performed during a tax year is made before the beginning of that year. Section 409A allows exceptions for the year in which a participant first becomes eligible to participate in a plan. The participant may make a deferral election within 30 days after initial eligibility. Regarding “performance-based compensation,” deferral elections are permitted as late as six months before the end of the service period, if the performance period is at least 12 months long.

Notice 2005-1 provides guidance on what constitutes performance-based compensation. Pending additional guidance, compensation is performance-based if it is contingent on organizational or performance criteria that are not substantially certain to be met at the beginning of the period. Subjective criteria are permissible if they are related to individual performance or performance of a group that includes the service provider, and assessment of whether the subjective criteria have been met is not made by the service provider (or a family member). Neither shareholder nor compensation committee approval is required. Significantly, bonus compensation is not considered performance-based compensation if it is based solely on the value of, or appreciation in the value of, the service recipient’s stock.

The Notice specifically provides that future guidance on this definition may be more restrictive.

Section 409A also provides that the plan or election must include the timing and form of distribution and those must comply with the new provisions. If the plan gives participants a choice of when to receive a distribution, that choice must be made based on the elective deferral rules.

B. Distributions From Plans

Under prior law, the only restrictions on the time and manner of distribution of deferred compensation were those that stemmed from section 451 and the constructive receipt doctrine. Employees could have access to funds as long as there was a substantial limitation on receipt. Section 409A permits a nonqualified deferred compensation plan to make distributions only following the occurrence of one of the events described below.
Observations
Pending further guidance, the definition of performance-based compensation is relatively broad, with the notable exception of the use of stock value or appreciation as a benchmark for performance. Stock appreciation over the fair market value on the date of grant is one of the accepted methods for providing performance-based compensation under section 162(m), the limitation on compensation deductions for the CEO and next four highest paid officers of a publicly traded company.

For fiscal-year companies, deferrals of bonuses that do not qualify as performance-based compensation should be made by the end of the calendar year ending before the year in which the fiscal year begins. This issue may be addressed in future guidance. In the interim, transition guidance for 2005 allows additional time before the election is required (see discussion below).

Notice 2005-1 provides guidance with respect to the definition of “change in control.”

1. Change of control of the employing corporation or change in ownership of a substantial portion of the corporation’s assets. The Notice adopts the basic structure of the definition of change in ownership or control under section 280G, as directed by the legislative history. The Notice does make some revisions.

A change in ownership or control occurs with respect to a service provider only if the change in ownership or control occurs to the entity to which the service provider provides services, or which is liable for payment of the compensation, or an entity in the chain of ownership above one of these entities.

a. Change in ownership. A change in ownership occurs if a person, or persons acting as a group, acquires, together with stock held by the person or group, more than 50 percent of the stock of the corporation, measured by voting power or value. Incremental increases in ownership by a person or group that already owns 50 percent of the corporation is not a change in ownership.

b. Change in effective control. A change in effective control occurs if a person, or persons acting as a group, acquire 35 percent of the stock of the corporation, by vote, over a 12-month period, or a majority of the members of the board of directors is replaced by directors not endorsed by the members of the board before the appointment. A change in board is relevant only if the change occurs in the parent corporation. For purposes of section 280G, the stock transfer threshold is 20 percent. Also, unlike 280G, that is not a rebuttable presumption.

c. Change in ownership of a substantial portion of a corporation’s assets. A change in control based on the sale of assets occurs if a person, or persons acting as a group, acquires 40 percent or more of the gross market value of the assets of a corporation over a 12-month period. No change in control results if the assets are transferred to specified entities controlled directly or indirectly by the shareholders of the transferring corporation. For 280G purposes, sale of one-third of the assets triggers a change in control.

Under the Notice, it is permissible for more than one corporation involved in a transaction to have a change in control for purposes of section 409A. Also, it is permissible for a company to exercise discretion whether to allow a distribution on a change in control and to specify some changes in control as permissible distribution events as opposed to others.

Observations
The definition of change in control applies only to corporations. During the transition period, the consequences for noncorporate entities involved in transactions are not as significant because of the flexibility regarding termination of arrangements. On an ongoing basis, however, limiting this definition to corporate entities will have consequences for noncorporate entities.

C. Other Distribution Events
The following are the other circumstances under which section 409A allows for distributions.

1. Separation from service. An individual may receive a distribution on separation from service except that a distribution to a “specified employee” must be delayed at least six months (or until death, if earlier). Specified employees are employees of a corporation with publicly traded stock (traded on an established market or otherwise) who (i) own more than 5 percent of the stock of the corporation; (ii) own more than 1 percent of the stock of the corporation and have compensation from the corporation in excess of $150,000 a year (not indexed); or (iii) are officers of the corporation with compensation in excess of $130,000 a year (indexed). Whether someone is an officer is based on the nature of his duties, not on his title, and no more than 50 employees can be considered officers. (The limit on the number of officers is 10 percent of all employees if the corporation has 30 to 500 employees and 3 if it has fewer than 30.)

2. Disability. An employee is “disabled” if the employee is unable to engage in any substantial gainful activity, or if the employee receives benefits for at least three months under the employer’s disability plan, as a result of any medically determinable physical or mental impairment that is expected to result in death or continue for at least 12 months.

3. Death.

4. A specified time (or under a fixed schedule) specified under the plan. At the time of the deferral, the plan may allow a participant to specify a fixed time or schedule when a distribution will be made. The employee must select a currently ascertainable date, not one that is contingent on some event. The employee could not, for example, specify “the date on which profits reach X” or “the date dividends are paid to common shareholders.” The distribution may be spread over a future period.
according to a fixed schedule, if desired. It would be permissible to elect substantially equal installments over 10 years, beginning at age 65, or a distribution of 25 percent of the value of the deferred compensation at age 60, 50 percent at age 65, and the remainder at age 70, or any similar pattern.

5. Unforeseeable emergency. The statute’s definition of "unforeseeable emergency" is based on the one provided by the regulations under section 457. Included are severe financial hardships arising from illness or accident (of the employee, his spouse, or dependents), casualty loss or "other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant." The amount distributed may not be more than what is reasonably necessary to meet the emergency and pay any anticipated tax on the distribution.

A plan may provide for more than one type of distribution event. It could, for example, state that distribution of deferred compensation will begin on the earliest of death, disability, an unforeseeable emergency, or attainment of age 62. The distribution events must, however, be chosen at the time of the initial deferral. It is no longer permissible to let a participant wait until just before separation from service to choose how benefits will be distributed.

D. Redeferral Elections
A participant may elect to postpone distributions that he would otherwise receive, if the following conditions are met:

- A redeferral election is made not less than 12 months before a scheduled payment.
- The election is effective no earlier than 12 months after it is made (that is, if a distribution event occurs after the redeferral election and before the end of 12 months or such later period as directed in the redeferral election, distribution must then be made in accordance with the original distribution method).
- The redeferral must be for at least an additional five years, or on death, disability, or unforeseeable emergency. A distribution cannot be made for separation from service or change in control during that period.

E. Prohibition on Acceleration of Distributions
The Act prohibits any acceleration of a distribution, except as provided in regulations. The Notice provides for some circumstances in which an accelerated distribution would be permissible.

1. Accelerated distributions. The most significant exception concerns the ability of a plan to set a de minimis distribution threshold. A distribution of a participant’s entire interest can be made under the plan if the payment occurs before the later of the end of the year in which, or within 2½ months after, the participant separates from service and the distribution does not exceed $10,000.

Also, a plan can add a distribution provision for future deferrals that sets the allowable distribution threshold at any level. That allows a plan to adopt, prospectively, a provision that allows an installment election to be overridden if the participant’s entire interest does not exceed a specified level.

Other situations in which accelerations are permitted include:
- in accordance with a domestic relations order;
- as necessary to comply with federal conflicts of interest requirements;
- under a section 457(f) plan, to allow for compliance with withholding requirements as a result of income inclusion under section 457; and
- under any plan, to allow for payment of applicable employment taxes and any additional taxes as a result of these distributions.

For those permissible acceleration rules, plans are not aggregated into nonaccount balance, account balance, and other plans. Plans are still deemed to be individual arrangements on a service provider by service provider basis.

2. Accelerated vesting. Under the Notice, accelerated vesting is permissible. However, distribution from a nonqualified deferred compensation plans with accelerated vesting must continue to comply with section 409A. Such an arrangement cannot take advantage of the exception to nonqualified deferred compensation, unless the original plan required distributions within a short time after vesting.

V. Transition Relief: Issues for 2005
Notice 2005-1 provides service recipients and service providers with the opportunity to bring deferrals that are subject to section 409A into compliance with its requirements during 2005. Overall, Notice 2005-1 provides a great deal of flexibility regarding how the transition is made, provided that the nonqualified deferred compensation plan is operated in good faith in accordance with the requirements of section 409A.

Section 409A applies to amounts deferred after December 31, 2004, and to amounts deferred before January 1, 2005, under a plan that is materially modified after October 3, 2004. This section first reviews the guidance
on what previously deferred amounts are not subject to the new rules, and then reviews the transition guidance provided in Notice 2005-1.

A. Grandfathered Amounts

In general, the amount considered grandfathered is the amount the participant would receive if he or she were to stop providing services to the employer on December 31, 2004. Earnings related to a grandfathered amount also avoid application of the new rules.

A participant will be considered to have a deferred amount before January 1, 2005, only if the participant has both a legally binding right to the deferred amount (discussed above) and the amount is earned and vested. For that purpose, an amount is considered vested if it is not subject to a substantial risk of forfeiture as defined in the section 83 regulations (for example, subject to a requirement to perform future services). Retention of discretion by the service recipient makes the payment not a legally binding right.

Observations

The use of the definition of substantial risk of forfeiture under the section 83 regulations narrows the scope of the grandfather. For example, an arrangement that provides for extension of a substantial risk of forfeiture after the beginning of the service period is considered vested for purposes of ongoing compliance with section 409A, but as unvested for purposes of determining grandfathered amounts. Whether the definition of “legally binding” right is similarly narrowed is not as clear, although the reference to discretion without further language regarding the likelihood that discretion will be exercised may indicate an intent to interpret this aspect narrowly as well.

The actual amount covered by the grandfather is determined by reference to the type of plan. For non-account balance plans, the grandfathered amount is the present value of the participant’s accrued benefit, without adjustment for upticks in final average compensation or for subsequently earned early retirement subsidies. Actuarial present value is based on the assumptions in the plan, if reasonable, or, if not, reasonable actuarial assumptions. Increases in the actuarial present value of benefits would be considered earnings and thus grandfathered. The definition of “plan” that would aggregate all nonaccount balance plans into one does not apply for that purpose. As a result, different nonaccount arrangements can provide for different actuarial assumptions.

For an account balance plan, the grandfathered amount is the December 31, 2004, account balance, including future earnings (such as notional interest) on that amount.

For equity-based compensation plans, the grandfathered amount is the amount payable on December 31, 2004. For options and other appreciation rights, the grandfathered amount is the intrinsic value (the difference between the exercise price and the fair market value). Increases in value due to appreciation in the value of the underlying stock are considered grandfathered amounts.

1. Material modifications. If a plan is “materially modified” after October 3, 2004, regarding otherwise grandfathered amounts, then those amounts will become subject to section 409A. As discussed below, changes to a plan to bring it into compliance with section 409A are not material modifications. Thus, to the extent that amounts deferred under a plan are subject to section 409A and are brought into compliance during 2005, those changes do not constitute material modifications that taint otherwise grandfathered amounts.

Material modifications are changes to a plan, either by amendment or exercise of discretion, that enhance or add a benefit, right, or feature. Examples given in the Notice are the addition of a 10 percent haircut provision or acceleration of vesting that would make a benefit earned and vested by December 31, 2004. Changes in investment measures (for example, notional interest rates) are not a material modification.

While amendments to conform to section 409A are not a material modification, selective amendments that would conform a plan to one or more of the rules of section 409A will still result in a material modification, causing all amounts under the plan to lose grandfathered status. However, if a plan as of October 3, 2004, included those provisions, exercise of employer discretion regarding time or method of payment or exercise by an employee of a right provided under the plan are not material modifications.

The Notice provides that it is permissible for benefits granted after October 3, 2004, that vest by the end of 2004 to be covered by the grandfather and not considered additional benefits resulting from a material modification, depending on the facts and circumstances. The example given in the Notice is a grant of SARs in November 2004 that is consistent (in terms and amounts) with grants made in November each year.

The Notice also provides that, if additional benefits are added, only those benefits are considered subject to section 409A. The provisions of the plan regarding those benefits can be revised in accordance with the general transition rules.

B. Transition Relief

1. Introduction. Notice 2005-1 provides flexibility to amend an arrangement or deferral election during 2005 to bring it into compliance with section 409A through revisions or to terminate it. An important element of that relief is that the plan be operated in good-faith compliance with section 409A and that the plan documents be amended by December 31, 2005, to comply with the operation as well as section 409A. Good-faith compliance includes adherence to the principles set forth in Notice 2005-1 as well as to good-faith interpretations of other provisions of section 409A.

Because the definition of plan is on a service provider by service provider basis, different decisions are permitted regarding different service providers. Thus, an employer may offer each employee the option of either terminating an arrangement or agreeing to revisions, or...
make the decision for all employees. Similarly, the employer is permitted to offer choices regarding the way in which revisions will be made or to offer only a single approach to revisions.

In each case, there is a distinction between transition available for amounts subject to section 409A and grandfathered amounts. As noted earlier, the amendment of a plan to bring it into compliance with section 409A is not considered a material modification. Thus, for many employers, a threshold question will be whether to seek to preserve the grandfather or to use the transition methods available to bring all amounts into compliance with the new provisions.

2. Plan revisions.

a. Changes in payment elections. Plans are permitted to offer participants the ability to change payment elections without regard to the redefferral or acceleration provisions of section 409A on or before December 31, 2005. That relief applies to amounts that otherwise comply (or are brought into compliance with) section 409A. That allows participants to elect to accelerate payments or delay payment without regard to whether there is an election 12 months in advance of a scheduled payment or a five-year redefferral period. Holders of options or SARs (that would not otherwise comply with section 409A) may also change payment elections to permissible distribution dates.

b. Options granted at a discount. The Notice further provides that it is not a material modification to either reissue an option or SAR that had a discount at grant to one without a discount or modify such a grant into an arrangement that would otherwise comply with section 409A, that is, through the use of permissible distribution provisions if cancellation and reissuance occurs before December 31, 2005. Those methods would also seem reasonable as methods of converting an arrangement that is subject to section 409A into an arrangement that complies with its requirements.

3. New elections. For a plan in existence on or before December 31, 2004, deferral elections made on or before March 15, 2005, are effective for amounts not yet paid or payable, without regard to the requirement of section 409A(a)(4)(B) that elections be made by the end of the year before the year in which the service period begins. As with other requirements, that relief is conditioned on the plan being operated in good faith with section 409A and amended to reflect the provisions of section 409A and the additional deferral election opportunity by December 31, 2005.

Observations

As the end of 2004 approached, some employers with deferred compensation plans froze the election process while others sought to have employees make elections knowing that the terms of the plan would have to change in 2005. The Notice provides relief in both situations, by allowing an additional opportunity to make elections before March 15, 2005, and by allowing elections to be revised or revoked by December 31, 2005.

The special election provision is limited to plans in effect on or before December 31, 2004. The aggregation rule for “plan” is not disregarded for purposes of this relief. Therefore, if, for example, an account balance deferral arrangement was in effect for a participant, then there was a plan in effect, even if the terms of the plan post-effective-date will be revised. For employers that did not have a plan in effect, the ability for participants to make elections in 2005 will hinge on the exception for newly eligible participants to make elections during the first 30 days of eligibility.

As a final note, the ability to make deferral elections until March 15, 2005, should be reviewed by employers that provide fiscal-year bonuses that do not meet the interim definition of performance-based compensation. In those situations, an election made by March 15, 2005, would apply to the bonus payable for the service period beginning in calendar year 2005.

4. Election revocations and plan terminations. For plans adopted before December 31, 2005, another alternative is
to allow for revocation of elections or termination of the plan. That option is available both for amounts subject to section 409A and to amounts that would otherwise be grandfathered but choose to comply with section 409A.

The plan may be amended to give participants the right to revoke, completely or in part, a deferral election without causing the plan to fail to comply with section 409A or with the doctrine of constructive receipt. All amounts subject to the revocation must be includable in income in 2005 or the year in which the amounts become earned and vested, if later. In other words, participants with unvested benefits may be given the choice in 2005 to receive an immediate distribution of these amounts once they become vested.

For amounts deferred on or before December 31, 2004 (grandfathered amounts), the termination must include the participant’s benefits under the plan, with all amounts under the plan includable in income by December 31, 2005. Plans are not aggregated for that purpose, however, so that a participant’s interest in one arrangement may be terminated but other arrangements continued. Unlike the provisions for plans subject to section 409A, the Notice does not provide explicit relief from constructive receipt. Therefore, participants cannot be given a choice regarding termination of grandfathered amounts unless the plan is amended to comply, and operates in good-faith compliance, with section 409A. The provision for grandfathering plans allows employers to exercise a right to terminate the plan on or before December 31, 2005.

5. Mirror plans. During 2005 nonqualified deferred compensation plans under which payment is linked to an election under a related qualified plan are permitted to make distributions in accordance with plan terms as of October 3, 2004. That relief applies to plans linked to plans qualified under section 401(a). The Notice notes that constructive receipt and other common-law doctrines continue to apply.

6. Severance plans. During 2005 severance plans that cover collectively bargained employees or only employees who are not key employees are not required to comply with section 409A. That relief is conditioned on the plan being amended by the end of 2005 to comply with section 409A.

VI. Funding Arrangements for NQDC

Section 409A eliminates two funding techniques for securing the payment of deferred compensation to executives. Under prior law, nonqualified deferred compensation is includable in gross income to the extent the employer secures payment by placing assets beyond the reach of the employer’s creditors if the company’s financial condition deteriorates. Section 409A adds two circumstances in which funding associated with nonqualified deferred compensation results in current income: offshore rabbi trusts and so-called financial health trigger trusts.

A “rabbi trust” is subject to the claims of the employer-grantor’s general creditors in the event of the employer’s bankruptcy. Section 409A provides that a trust that is located outside the United States, regardless of whether the trust is subject to the claims of the employer’s creditors, results in current income. That rule does not apply if substantially all of the services that gave rise to the deferred compensation were performed outside the United States in the jurisdiction in which the assets are held. The use of rabbi trusts in the United States is unaffected by this offshore funding provision.

Another technique that some employers used to secure the payment of deferred compensation was to provide that assets will be placed beyond the reach of the employer’s creditors if the company’s financial condition deteriorates. Section 409A provides that a plan that includes a provision of that sort, or that provides for establishment of a rabbi trust in the event of a financial health event, is treated as funded, leading to immediate tax liability.

Notice 2005-1 does not provide guidance on the scope of this provision, or for other exceptions.

VII. Reporting and Withholding Obligations

A. Reporting Requirements

1. Deferral of compensation. The Act also adds reporting obligations for deferred compensation. Effective for amounts deferred after December 31, 2004, service recipients are required to include information on deferrals on Forms W-2 (for employees) and 1099-MISC (for independent contractors), if either form is otherwise required to
As an initial matter, individuals subject to U.S. income tax will be subject to the requirements of section 409A if they are covered under a “nonqualified deferred compensation plan” without regard to whether there is a trust associated with an arrangement or without regard to the jurisdiction in which services are performed. Section 409A requires a review of those arrangements, taking into account other applicable code provisions and any applicable treaties. Some will require revisions or separate arrangements if U.S. taxpayers are to avoid tax under section 409A.

Turning to funding, the restriction on offshore trusts has raised many questions involving multinational corporations and the provision of benefits. First, there are issues associated with funded arrangements overseas, some of which are functional equivalents to domestic qualified plans. Before the enactment of section 409A, the taxation of those benefits for individuals subject to U.S. income tax was governed by section 402(b) and, as applicable, treaties.

Second, there are questions related to foreign nationals who become subject to U.S. income tax, while participating in a trust in a foreign jurisdiction.

The application of this provision is further complicated by a proposed technical correction, still not enacted, that would provide that section 409A applies to an offshore trust after December 31, 2004, rather than only to an offshore trust the assets of which are available for amounts deferred after December 31, 2004. The technical correction would also allow a transition period to enable taxpayers to conform operation to comply with the rules.

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be filed. Those amounts are reportable using Code Y in Box 12 of Form W-2 and in Box 15a of Form 1099-MISC.

This requirement also applies to income attributable to amounts deferred after December 31, 2004. Amounts deferred before January 1, 2005, are not required to be reported. For that purpose, amounts are “deferred” when there is a legally binding right to the compensation, without regard to whether the amounts are earned and vested and without regard to whether a plan in existence on October 3, 2004, has been materially modified. Thus, some amounts that are not considered grandfathered for purposes of section 409A are nevertheless not required to be reported because they are considered pre-2005 deferrals for reporting purposes.

There are two exceptions to the reporting obligation. First, although the requirements apply to both account balance plans and nonaccount balance plans, amounts deferred under a nonaccount balance plan are not required to be reported until those amounts are readily ascertainable, under the generally applicable rules regarding FICA tax on deferred compensation under section 3121(v). Second, there is a de minimis exception for deferred compensation for an employee that applies if the aggregate amount of deferrals under all deferred compensation plans for an individual employee does not exceed $600. Note that section 6041 provides a general de minimis exception from reporting on Form 1099 for payments of less than $600.

2. Taxable of deferred compensation. Deferred compensation includable in an employee’s gross income as a result of section 409A is reported as wages on Form W-2, Box 1, and in Box 12, using Code Z. Deferred compensation includable in income should be reported on Form 1099-MISC, Box 7, and in Box 15b to the extent not reported as wages, if the individual is one for whom a Form 1099-MISC is otherwise required to be filed.

3. Expedited Forms W-2 during 2005. For most employers, Forms W-2 reflecting the new reporting requirements will not be required to be provided to employees until January 2006. If an expedited Form W-2 is issued before further guidance, amounts related either to deferrals or inclusion in income of deferred compensation does not have to be reported. However, a revised Form W-2 will need to be issued once guidance is provided.

B. Wage Withholding

Amounts includable in income under section 409A are subject to income tax withholding. For 2005 those amounts can be treated as paid by the employer as of any date on or before December 31, 2005, unless the amount is also actively or constructively received during the year. If the payment is actually or constructively received, withholding is required as of the date of actual or constructive receipt.

C. SECA and FICA Tax

Amounts included in income under section 409A are generally included in self-employment income for purposes of tax under the Self-Employment Contributions Act (SECA).

The tax treatment of deferred compensation for FICA purposes is not affected by section 409A. Thus, the taxation of those amounts under section 3121(a) or 3121(v)(2), as appropriate, is not changed.

VIII. What Is the Future for NQDC?

Section 409A requires sweeping changes to some nonqualified deferred compensation arrangements and at least some revision to many more. Notice 2005-1 provides generous transition relief in 2005, allowing employers time to consider the appropriate response to those changes, from the perspective of employees and other service providers, employers, and shareholders. At the same time, companies are faced with changing requirements for accounting for equity-based compensation in 2005 and the increased focus on corporate governance and shareholder responsiveness regarding many items, including compensation.

Economics and employee relations. An important first step to assessing changes to nonqualified deferred compensation is understanding the current compensation package: What is it worth to employees? What do they value about the current arrangement? What does it take to be competitive in the marketplace?

For every nonqualified deferred compensation plan, there is more than one possible design. In some cases, it
will make sense to modify an existing arrangement for future years. For some employers, now is the time to consider switching from deferred compensation to current compensation, or from stock options to other methods of providing performance-based compensation. In either case, changes can enhance or detract from the value to employees. Similarly, those changes can be cost efficient, cost-neutral, or increase the cost to the employer. Those costs can be direct, or indirect, for example in terms of the potential loss of deduction under section 162(m), which limits deductions for remuneration to the CEO and the next four highest paid officers of a publicly traded corporation. Determining the proper next step requires knowing where you stand.

**Compliance and cost.** The Act brings with it not just new tax provisions for nonqualified deferred compensation, but also new reporting requirements. Also, the IRS is increasingly focusing audit activity toward compensation. The executive compensation audit initiative was launched in November 2003 and continues in an expanded form. Reports to date indicate that the IRS intends to proceed with its plan of incorporating at least some issues related to executive compensation as part of standard audit procedures for many taxpayers. The recently revised Schedule M-3 necessitates a much greater degree of reporting for compensation items when financial reporting and tax treatment differs.

As employers review changes to nonqualified deferred compensation, they should consider the costs of administering plans, how much complexity is warranted, and whether the plans can be administered in a way that is procedurally sound from a reporting and compliance perspective.

**Coordination with accounting changes.** Section 409A will reduce an employer’s ability to grant stock options with an exercise price below fair market value at grant and will constrain how options and SARs are converted in connection with mergers and acquisitions. At the same time, as employers become increasingly global, the treatment of compensation for foreign employees subject to U.S. tax or amounts held overseas is a more significant issue. The revisions required by section 409A and FAS 123(R) provide employers with the opportunity to review global compensation with an eye toward a program that is consistent across borders taking into account economic, tax, and accounting results.

**Corporation governance and shareholder disclosure.** These days, shareholder groups and representatives are looking for more and more disclosure on executive compensation and for confirmation that companies understand the importance of these issues.

Section 409A brings with it challenges and opportunity. The transition to the new requirements is just one challenge employers face within the area of executive compensation. The process of deciding how to compensate executives going forward is one that should involve different perspectives, both regulatory and economic. The ultimate goal is enabling companies to recruit and retain the individuals they need to compete, benefiting employees, the companies, and shareholders.