

# Nonqualified Deferred Compensation Plans

Dec 01 2005

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Practice Area: Compensation and Benefits/ERISA

In October 2004, Congress passed the American Jobs Creation Act of 2004, which added Section 409A to the Internal Revenue Code. Section 409A imposes significant restrictions on the form and operation of nonqualified deferred compensation plans ("NDCPs"). Failure to comply with Section 409A subjects amounts deferred under the NDCP to immediate taxation, as well as a 20% excise tax.

On September 29, 2005, the IRS issued extensive proposed regulations regarding Section 409A. While the proposed regulations incorporate many of the issues that the IRS addressed in a previously issued Notice (Notice 2005-1), they also provide guidance on the scope of Section 409A and clarify the rules for deferral elections and distributions under plans subject to Section 409A.

The proposed regulations generally allow employers that sponsor NDCPs to wait until December 31, 2006, to amend their plans to comply with Section 409A. However, all NDCPs that are subject to Section 409A must currently be operated in good faith compliance with Section 409A. In addition, as described below, employers may wish to take certain actions before the end of 2005 to avoid the application of certain aspects of this new law.

## **Scope of Section 409A**

The proposed regulations apply to amounts deferred after December 31, 2004 under plans (other than certain retirement plans, such as qualified plans, 403(b) plans and eligible 457(b) plans) that provide for the "deferral of compensation." They also apply to amounts deferred prior to December 31, 2004, under plans that are materially amended on or after October 3, 2004. Significantly, a "plan" of deferred compensation can include even a single agreement to provide future compensation to a single employee.

A deferral of compensation occurs if an employee or other service provider has "a legally binding right" to receive compensation in a future year, if that compensation has not yet been includible in gross income. Generally, an employee has a legally binding right to receive future compensation unless an employer has an unfettered, discretionary right to unilaterally reduce or eliminate an employee's compensation after the services generating the compensation have been performed. A legally binding right to compensation may exist even where the right is subject to conditions that constitute a substantial risk of forfeiture, such as a requirement that the employee work until a certain age before the right to receive deferred compensation is vested. If an employer's discretion to reduce or eliminate the compensation is unlikely to be exercised or otherwise lacks substantive significance, the employee will be considered to have a legally binding right to payment.

### **1. Short-Term Deferrals**

A deferral of compensation does not occur if an amount is actually or constructively received by the employee by the later of:

- 2½ months after the end of the employee's taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or

- 2½ months after the end of the employer's taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

For these purposes, an amount is subject to a "substantial risk of forfeiture" if payment is conditioned upon the performance of substantial future services. Any extension of the period of time during which the payments are subject to a risk of forfeiture are disregarded in determining when the risk of forfeiture lapses. In addition, a noncompete agreement does not constitute a substantial risk of forfeiture for these purposes.

Amounts qualify for this short-term deferral exception if the payment is made within the 2½ month period, regardless of whether this requirement is written in the plan document. However, if a payment date is written in the plan document and a payment of compensation is made after the 2½ month period but before the end of the calendar year, the payment is Section 409A compliant. If a payment is not written in the plan and a payment of compensation is made after the 2½ month period, there is an automatic violation of Section 409A. Payments of compensation can also be made as soon as practicable after the 2½ month period if the reason for delay is attributable to administrative or solvency issues.

## **2. Certain Separation Pay Arrangements**

Separation pay is defined as any compensation that is conditioned on a voluntary or involuntary separation from service. An amount payable due to a separation from service constitutes separation pay regardless of whether payment is conditioned upon a release of claims, noncompetition or nondisclosure provisions, or other similar requirements.

Significantly, many separation pay arrangements, including those found in employment agreements, will be subject to Section 409A. A separation pay arrangement will be outside the scope of Section 409A only if:

- (a) the payment is made pursuant to an actual involuntary separation from service or pursuant to a window program;

- (b) the amount of the severance payments does not exceed the lesser of:

- (i) two times the employee's annual compensation; or

- (ii) two times the limit on annual compensation that may be taken into account under a qualified plan under Code section 401(a)(17) (\$210,000 for 2005); and

- (c) all payments under the arrangement are to be made no later than the end of the second calendar year following the year in which the employee terminates service.

In addition, certain collectively bargained separation pay arrangements, de minimus separation pay arrangements (less than \$5,000), and reimbursements or direct payment of otherwise excludible or deductible expenses, are excepted from Section 409A.

## **3. Certain Stock Options and Stock Appreciation Rights**

Generally speaking, an incentive stock option (*i.e.*, an option that satisfies the requirements of Section 422 of the Internal Revenue Code) is not subject to Section 409A. The proposed regulations provide that a nonqualified stock option is not subject to Section 409A if:

- (a) the number of shares subject to the option is fixed at the date of the grant of the option;

- (b) the option is granted for not less than the fair market value at the date of grant of the option;

- (c) the option is taxable under Code section 83; and

(d) the option does not include any additional deferral features.

The rules for stock appreciation rights (“SARs”) are similar. Under the proposed regulations, a SAR will not be considered deferred compensation provided:

(a) the compensation from the SAR is not greater than the difference between the fair market value of the stock on the date of grant and the fair market value of the stock on the date of exercise;

(b) the SAR’s exercise price may never be less than the fair market value of the underlying stock on the date of grant; and

(c) the SAR does not include any feature for the deferral of compensation.

Only common stock that is readily tradable on an established securities market, or if none, the class of common stock having the greatest aggregate value of common stock issued and outstanding by a corporation may be used for purposes of awarding options or SARs.

In drafting agreements for the award of options or SARs, care should be taken not to include features that could effectively cause the exercise price to fall below fair market value. For example, the right of an optionee to receive, upon exercise of the option, an amount equal to all dividends declared on the underlying stock between the date of grant and the date of exercise constitutes an offset to the exercise price of the option, unless that right is set forth in a separate agreement that itself complies with Section 409A.

#### **4. Certain Split Dollar Life Insurance Agreements**

Split dollar life insurance arrangements are not excluded from the requirements of Section 409A. In its commentary to the proposed regulations, the IRS identified only two types of split-dollar life insurance arrangements that fall outside of the definition of deferred compensation: (a) split-dollar life insurance arrangements that provide only death benefits to or for the benefit of the employee; and (b) split-dollar life insurance arrangements that are treated as loan arrangements (provided that there is no agreement that the loan will be forgiven and no obligation that the employer continue to make premium payments without charging the employee a market interest rate). Endorsement split-dollar arrangements, where the employer is the owner of the policy but the employee retains a legally binding right to compensation includible in gross income in a taxable year after the year in which a substantial risk of forfeiture lapses, are not excluded from Section 409A.

### **Initial Deferral Election Rules**

#### **1. General Rule**

Generally, Section 409A requires that an initial election to defer compensation must be made by the close of the year preceding the year in which compensation subject to the deferral election is earned. The election must include the time and form of payment and must be irrevocable as of the deadline for making the election.

#### **2. Performance-Based Compensation**

In the case of performance-based compensation, an employee’s initial deferral election must be made no later than six months before the end of the 12 month period over which performance is measured. Performance-based compensation is compensation that is contingent on the satisfaction of pre-established organizational or individual performance criteria over a performance period of at least 12 consecutive months in which the employee performs services. The performance criteria must be established in writing within the first 90 days of the performance period and the achievement of the criteria must be substantially uncertain at the time the criteria are established.

#### **3. First Year of Eligibility**

An initial election to defer compensation may be made within 30 days after the date an employee first becomes eligible to participate in a plan. An employee is treated as a new participant in a plan only if he or she has not previously participated in any plan of a similar type maintained by an employer.

#### **4. Fiscal Year Compensation**

Section 409A requires an employee to make an election to defer fiscal year compensation by the beginning of the first fiscal year in which any of the relevant services are performed. "Fiscal year compensation" is compensation relating to a period of service coextensive with one or more consecutive fiscal years of the employer. Thus, if an employer is to pay an employee a bonus based upon service during the employer's October 1, 2006 to September 30, 2007 fiscal year, the employee may elect to defer the bonus at any time prior to October 1, 2006.

#### **5. Commissions**

Generally, if an employee's right to commission compensation is contingent upon a customer making a payment, an initial election to defer the commission compensation must be made prior to the year in which the customer renders payment.

#### **6. NDCPs Linked to Qualified Plans**

Amounts payable under many NDCPs are determined by reference to benefits payable under an employer's qualified retirement plan. For example, some NDCPs provide that salary deferrals in excess of the maximum amounts that may be deferred into a 401(k) plan will be paid under the NDCP. Other NDCPs provide a formula for determining benefits, and offset those benefits by amounts paid under the employer's defined benefit plan. The proposed regulations list specific situations where an action or inaction of an employee or employer with respect to a qualified plan will not be considered a deferral of compensation under a NDCP linked to the qualified plan, even if the action or inaction results in changes in benefits payable under the NDCP. For example, suppose an employee adjusts his or her salary deferral election under a 401(k) plan, and the adjustment impacts amounts deferred under a linked NDCP. Under the proposed regulations, this action will not be considered a deferral election under the NDCP, as long as the amounts deferred under all NDCPs in which the employee participates do not increase by more than the salary deferral limit in effect for the 401(k) plan for that year.

#### **Subsequent Elections Regarding Deferred Compensation**

Section 409A provides that a participant may elect to change the time and/or form of distribution after an amount has been deferred only if the plan requires:

- (a) that the election may not take effect for at least 12 months;
- (b) that, except for an election relating to payments on account of disability, death or an unforeseeable emergency, the payment must be deferred for a period of not less than five years from the date the payment would have otherwise been made; and
- (c) that any election relating to a payment at a specified time or pursuant to a fixed payment schedule must be made at least 12 months prior to the date the payment is scheduled to be made.

#### **Distribution Rules**

The proposed regulations provide that payments be made no earlier than a fixed date or under a fixed schedule or upon any of five events;

- a separation from service;
- death;
- disability;
- certain changes in ownership or effective control of a corporation (as defined in the proposed regulations); or
- an unforeseeable emergency.

#### **1. Objective Payment Date Required**

For a payment to be made as a result of one of the events listed above, the plan must designate an objectively determinable date following the event upon which the distribution is to be made. A statement that payments will be made as soon as practicable after a triggering event will likely violate Section 409A.

## **2. Multiple Payment Events**

A plan may provide for distributions upon the earlier of or the later of two or more specific permissible events. A plan may also provide for different forms of distribution depending upon the actual triggering event. For example, a plan may provide that distributions will be the later of the date a participant attains age 60 or separates from service. In addition, the plan could provide that the participant will receive a lump sum payment if distribution is triggered by death of the participant, but will receive a series of installment payments if the distribution is triggered by separation of service.

## **3. Anti-Acceleration Provisions**

Section 409A generally prohibits the acceleration of payments under a NDCP. Notice 2005-1 and the proposed regulations list several exceptions, including:

(a) Intervening Event. A plan may provide that an intervening distributable event (*i.e.*, death) may override an existing distribution schedule already in pay status.

(b) Domestic Relations Order. A plan may allow acceleration of the time or schedule of payments to an individual other than the employee as necessary to comply with a domestic relations order.

(c) 409A Violation. A plan may provide for an accelerated distribution to pay the amount a participant must include in income as a result of a Section 409A violation.

(d) Plan Termination. The proposed regulations permit an employer to terminate a plan and distribute benefits without violating the prohibition on acceleration of payments of Section 409A under limited circumstances.

## **Transition Relief**

### **1. Good Faith Compliance**

Notice 2005-1 provided that a plan adopted before 2006 would not be treated as violating the requirements of Section 409A if:

(a) the plan is operated in good faith compliance with the provisions and guidance issued by the IRS; and

(b) the plan is amended by December 31, 2005 to conform to the provisions of Section 409A.

The proposed regulations extend this good faith compliance period and the December 31, 2005 deadline for amending plans to December 31, 2006. While compliance with all aspects of the proposed regulations is not required, compliance with the proposed regulations will be deemed good faith compliance.

### **2. Nonqualified Plans Linked to Qualified Plans**

In many NDCPs, the time and form of payment is controlled by the time and form of payment elected by the employee under a qualified retirement plan of the employer. Ordinarily, such a link would cause the NDCP to violate Section 409A. The proposed regulations allow NDCPs to retain a provision linking the time and form of payment to an election under a qualified plan, but only through the end of 2006.

### **3. Material Modifications**

Amounts deferred and vested before 2005 are not subject to Section 409A unless the plan under which the compensation is deferred is "materially modified" on or after October 3, 2004. Generally, a plan is materially modified if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. The proposed regulations provide that if a modification is rescinded before the earlier of the date any additional right granted under the modification is exercised or the end of the calendar year in which the modification was made, the modification will not be treated as a material modification of the plan. Therefore, an employer that materially modified a NDCP in 2005 must rescind the modification before the end of 2005 if it wants to avoid having the pre-2005 deferrals subject to Section 409A.

#### **4. Changing Payment Elections of Conditions**

The proposed regulations state that a NDCP may provide, or may be amended to provide, for new payment elections before the end of 2006 with respect to the time and form of payment. For example, a plan that only allows payments in installments may be amended to allow a participant to elect, during 2006, to receive payment of his or her deferred compensation in a lump sum. This type of election may only be made, however, with respect to amounts that would not otherwise be payable in 2006, and the election may not cause an amount to be paid in 2006 that would otherwise not be payable in 2006.

#### **5. Canceling or Terminating Plans**

Notice 2005-1 provided that a NDCP may be amended in 2005 to allow a participant to cancel a deferral election or terminate participation in the plan and receive a distribution in 2005 of amounts subject to the cancellation or termination. The proposed regulations do not extend this relief into 2006. This means that if elections to defer are to be revoked in whole or in part, the conforming amendments must be adopted and the revocation must be made by the end of 2005.

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