Proposed 409A Regulations: What You Need To Know For 2005

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On October 4, 2005, the IRS issued long-awaited proposed regulations under Section 409A regarding the treatment of nonqualified deferred compensation plans. Although most people immediately noted that the date for adopting conforming amendments to plans has been pushed back from December 31, 2005 (the date imposed by Notice 2005-1, issued in December 2004) to December 31, 2006, there is still much to be done before the end of 2005. This Benefits Alert will review the transition rules for becoming compliant with Section 409A, and because those transition rules are especially relevant to participant deferral elections, this Alert will also review with specificity the guidance the proposed regulations provide on that topic.

The Benefits Law Group of Holland & Hart LLP expects to issue three more Benefits Alerts in the next few weeks to cover other aspects of the proposed regulations in more detail. These Alerts will assume a general familiarity with Code Section 409A, so if you would like to refresh your knowledge in this area, please review our previous Benefits Alerts for background information on this topic.

Transition Rules – Some Deadlines Extended, Some Not

Notice 2005-1 required that nonqualified deferred compensation plan documents be amended to comply with Section 409A by the end of 2005. The proposed regulations extend that deadline to December 31, 2006. That extension is not a complete reprieve from 409A, however. Following are some issues to address immediately, or at least before the end of 2005:

- **Operational Compliance.** Section 409A itself is still effective for amounts deferred after December 31, 2004. This means that all nonqualified deferred compensation arrangements must be operated in good faith compliance with Section 409A, Notice 2005-1 and the proposed regulations.
- **Initial Deferral Elections.** Initial deferral elections relating to services performed on or before December 31, 2005 should have been made on or before March 15, 2005. The proposed regulations did not extend this relief, which means that for 2005 compensation, the March 15th deadline still holds. Elections for 2006 compensation must be made

before December 31, 2005.

- **Revocation of Elections to Participate in Nonqualified Arrangements**. Notice 2005-1 permitted participants until December 31, 2005 to decide whether to terminate participation in a nonqualified plan or cancel outstanding deferral elections with regard to amounts subject to Section 409A. If amendments to plans were necessary to allow revocation of elections, employers were permitted until December 31, 2005 to make such amendments. The proposed regulations do not extend these deadlines.
- **Termination of Nonqualified Arrangements**. An employer can completely avoid the application Section 409A to its plan if the plan is terminated by December 31, 2005 and all amounts deferred under the plan are distributed in 2005. The proposed regulations do not extend this deadline.
- **Avoid Material Modifications**. The proposed regulations incorporate the grandfather rule of Notice 2005-1, which stated that amounts deferred before January 1, 2005 would not be subject to 409A provided that the plan under which such amounts were deferred was not "materially modified" after October 3, 2004. The proposed regulations add a "mulligan" rule to the grandfather rule – you have until the end of the calendar year in which a material modification was adopted (or, if earlier, the date any additional right granted under the modification was exercised) to rescind that modification. This means that if you have adopted any amendments to deferred compensation arrangements in 2005, it would be a good idea to review them to decide if they would be material modifications, and, if so, to consider whether to rescind them before December 31st.

Relief Granted in Proposed Regulations

In addition to the deadline for actual amendments to nonqualified deferred compensation arrangement documents, the proposed regulations do provide relief from some other deadlines:

- **Adding New Payment Elections**. The proposed regulations extend the time for amending plans to provide new payment elections to December 31, 2006. Amendments to provide new payment elections will not violate the subsequent deferral and anti-acceleration rules of Section 409A as long as the election applies to amounts that would not otherwise be payable in 2006 and does not cause an amount to be paid in 2006 that would not otherwise be payable in that year.
- **Substitution of Forms of Equity Compensation**. The proposed regulations allow discounted stock options or stock appreciation rights to be exchanged for stock options or stock appreciation rights that do not constitute a deferral of compensation under Section 409A without violating the

Section 409A material modification rules, provided that the cancellation and reissuance occurs on or before December 31, 2006 and does not result in the cancellation of a deferral in exchange for cash or vested property in 2006.

- **Linked Plans**. Through December 31, 2006, election provisions under a nonqualified deferred compensation plan that mirror or depend upon elections under a qualified plan will not violate Section 409A as long as the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan as in effect on October 3, 2004.

Deferral Elections

Section 409A itself focuses on two types of deferral elections: the participant's initial decision to defer the compensation, and subsequent elections to delay payment or change the form of payment. Good faith compliance with these provisions is required now, and is most easily demonstrated by complying with the detailed additional guidance the proposed regulations provide on these topics. The following is a summary of the guidance provided in Notice 2005-1 and the proposed regulations on these topics.

- **Basic Election Rules**. A participant's election to defer compensation (and, if the arrangement permits, a participant's election as to the time and form of payment) must be irrevocably made before the end of the participant's taxable year immediately before the year in which the compensation will be earned. Typically, for individual participants, this means a December 31st deadline for making deferral elections. Where the participant first becomes eligible to participate in a deferred compensation arrangement, the deadline is extended until 30 days after the date of eligibility. The preamble confirms that elections that roll over from year to year unless affirmatively changed by the participant ("evergreen" elections) are permissible as long as the election for each year becomes irrevocable by the applicable deadline. For arrangements that allow participants to elect the time and form of payment, employer should consider the increased administrative burdens of allowing participants to change such elections each year.
- **Employer with Fiscal Year other than Calendar Year**. Section 409A's deferral rules are difficult to apply where compensation to be deferred is calculated according to the employer's fiscal year, which is not the calendar year. The proposed regulations permit the participant to elect to defer such compensation by the end of the fiscal year before the fiscal year in which the compensation will be earned.
- **Deferral of Short-Term Deferrals**. The proposed regulations add a provision permitting a participant to postpone receipt of amounts that otherwise would be exempt from 409A as a short-term deferral (generally, a

payment made within two and one-half months after the close of the plan year). The proposed regulations impose the second-deferral 12 month / 5 year rule on such an election. The example given in the preamble to the proposed regulations is most illustrative. If an employee is entitled to an immediate bonus in the event of his employer's initial public offering, the employee may defer receipt of that bonus as long as the election to defer is made at least 12 months in advance of the initial public offering, and the deferral is for at least 5 years after the initial public offering.

- **Deferral of Unforeseeable Mid-Year Awards**. In recognition of the fact that an unexpected mid-year award of deferred compensation (like a restricted stock unit award) does not permit the participant an opportunity to make an election as to time or form of payment by the previous December 31st, the proposed regulations permit participants in such situations to make a valid election within 30 days after the date of grant, provided that the grant is subject to the requirement that the participant remain in service for at least 12 months after the date of grant.
- **Performance-Based Compensation**. Section 409A provides that a deferral election with respect to performance-based compensation need not be made until six months before the end of the period over which performance will be measured. With the proposed regulations, we now have a definition of performance-based compensation. To meet this definition, the amount of or entitlement to the compensation must be contingent on the satisfaction of preestablished organizational or individual performance criteria relating to a performance period of at least 12 months. The criteria should be established in writing at least 90 days after the beginning of the service period, and must not simply incorporate a level of performance that is substantially certain to be met.
- **Linked or Offset Plans**. Amounts transferred from a qualified plan to a nonqualified plan do not constitute deferrals. Accordingly, the deferral election rules do not apply to these amounts. Additionally, the proposed regulations make it clear that if amounts are initially deferred under a nonqualified plan followed by a transfer from the nonqualified plan to a qualified plan of the maximum amount eligible for deferral under the qualified plan after the end of the relevant plan year, the transfer does not constitute an impermissible payment acceleration.
- **Separation Pay**. In drafting the proposed regulations, the IRS explicitly refused to include an exemption for severance pay. Instead, the regulations provide that deferral elections may be made in the case of "separation pay" at any time before the participant obtains a legally binding right to the compensation. For this purpose, separation pay must be

due to an actual involuntary separation from service (which itself is defined to exclude "same desk rule" type situations), and must be the subject of bona fide arm's length negotiations. Whether the participant has a legally binding right to compensation depends on the individual's status as an employee or consultant. The proposed regulations set forth two brightline rules for this determination

In the case of separation pay due to participation in a window program (which is also defined), the election must be made by the time the election to participate in the window program becomes irrevocable. The regulations relax this rule by excluding many types of compensation from the definition of separation pay, including collectively-bargained arrangements, arrangements structured to meet the Department of Labor's rules for severance plans, window programs, and reimbursement of amounts otherwise includable from gross income.

- **Commissions**. The proposed regulations provide that a participant will be treated as having performed the services to which commissions relate during the year in which the customer pays for the goods or services on which the commission is based. This rule will apply only (a) where a substantial portion of the participant's services consists of direct sale of a product or service to a customer, (b) where the participant's compensation consists of a portion of the purchase price of the product or service, or an amount calculated by reference to the volume of sales, and (c) where the compensation paid is contingent on the customer's payment for the product or service.
- **Nonelective Arrangements**. The proposed regulations provide welcome clarification with respect to arrangements that do not permit the participant to elect the time or form of the payment. If these nonelective arrangements specify mandatory times and forms of payment no later than the time the participant has a legally binding right to the compensation, they are not subject to the rule that the times and forms of payment must be specified before the year in which the compensation is earned.
- **Second-Deferral Elections**. In the years before Section 409A became effective, it was not uncommon for nonqualified deferred compensation arrangements to permit participants to defer their payments further, or elect a different form of distribution, as long as that election was made by December 31st of the year before the compensation was otherwise payable. Section 409A substantially restricted such second-deferral elections by requiring that they be made at least 12 months before the payment was to have been made, and that they defer payment (in most cases) to at least 5 years after the payment was to have been made.

> The proposed regulations clarify how to apply the second-deferral 12 month / 5 year rule to multiple payments, such as installment payments. The proposed regulations provide that installment payments are generally treated as a single payment occurring on the date of the first installment, unless the plan provides that the right to the series of installments is to be treated, at all times, as a right to a series of separate payments. Under the first approach, a set of installments could be changed to a lump sum that is payable five years after the first installment payment. Under the second approach, switching to a lump sum payment would require the participant to wait for a distribution until five years after the last payment.

If you have any questions, contact any of the attorneys in Holland & Hart's Benefits Law Group.

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