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Update on Guidance to New Deferred Compensation Law

Last October, we sent an Executive Compensation and Benefits E-Bulletin (“Benefits Bulletin”) of the newly passed American Jobs Creation Act of 2004 (“Act”) which added new Section 409A to the Internal Revenue Code that brought about significant changes to the way nonqualified deferred compensation arrangements need to be operated in order to be in compliance with the tax laws. In our earlier summary, we noted that the Act directed the Internal Revenue Service (“IRS”) and the Treasury Department (“Treasury”) to issue guidance within 60 days of enactment to provide a transition period for plans adopted prior to December 31, 2004 to come into compliance with the new rules with respect to amounts deferred post-2004 and to clarify questions remaining in the new law.

In late December 2004, Treasury issued IRS Notice 2005-1 (as clarified by IRS Notice 2005-5) to address many provisions of Section 409A, though additional guidance is forthcoming as more questions remain.

As you may recall, our earlier summary noted that new Section 409A significantly changed, among other things, the rules governing: (i) the election of deferred compensation; (ii) the restrictions on distributions of deferred compensation; and (iii) the acceleration of distributions of deferred compensation. If you would like another copy of our earlier Benefits Bulletin, please let us know.

Due to the uncertainty surrounding the timing and substance of the guidance, many nonqualified deferred compensation plans were amended prior to January 1, 2005, to comply with Section 409A for deferrals made after December 31, 2004. In addition, many individuals participating in nonqualified deferred compensation plans made

elections prior to January 1, 2005, in many cases before the guidance was issued, to defer income earned in 2005.

The guidance provided clarification on certain issues, including providing a new definition of a “change in control” for purposes of determining when a distribution following a change in control would be permitted. In addition, the guidance provides liberal transitional relief through calendar year 2005, during which all affected deferred compensation plans will need to be amended or terminated.

March 15 Deadline for Deferral Election Changes

Generally, Code Section 409A requires that deferral elections be made before the beginning of the taxable year. However, IRS Notice 2005-1 provides transitional relief for plans established prior to January 1, 2005. Participants in such plans may make a deferral election as late as March 15, 2005, as long as: (i) the election applies to compensation that has not been paid or made available at the time of the election; (ii) the deferral election is made in accordance with the terms of the plan in effect on or before December 31, 2005 (other than the requirement to make the election by March 15, 2005); (iii) the plan is otherwise operated in accordance with Section 409A with respect to deferrals subject to Section 409A; and (iv) the plan is amended prior to December 31, 2005 to comply with Section 409A. Therefore, if a participant did not make an election prior to January 1, 2005 to defer amounts to be earned in 2005, and the plan otherwise meets the above listed requirements, such individuals may make an election by March 15, 2005. Finally, it appears that this deadline applies only

to changes in elections that result in deferring a greater amount of compensation.

December 31 Deadline for Other Transitional Relief

Other significant items addressed by the guidance include:

- **Amendment Period.** Plan amendments to comply with Section 409A must be adopted by December 31, 2005. Until then, operational compliance with Section 409A, using the guidance contained in Notice 2005-1, and good faith compliance with topics not yet addressed by guidance are sufficient.
- **Change of Form or Time of Distribution.** Plans also may be amended to provide for new payment elections with respect to amounts subjected to Section 409A and deferred before the election, provided the plan is amended and the election is made on or before December 31, 2005. In addition, in an informal discussion with a Treasury representative, we have been advised that this provision would permit a participant to change his existing election as to timing and/or form of distributions without violating 409A so long as the election is made prior to December 31, 2005.
- **Plan Termination.** Section 409A generally prohibits a plan sponsor from terminating a covered plan and then making distributions. However, for a plan in existence prior to October 4, 2004 that has not been materially modified since that date, a plan sponsor may terminate the plan and make distributions on or before December 31, 2005, without it being considered a material modification that could trigger penalties under 409A.
- **Mirror Plans.** A nonqualified deferred compensation plan that makes distributions based upon the individual's election under a qualified plan will satisfy

Section 409A through December 31, 2005, provided that the plan is operated in conformance with its terms as of October 3, 2004.

- **Change in Control.** A plan may allow a plan sponsor the discretion to terminate the plan and make distributions within 12 months of a change in control event, as defined under the guidance, provided, prior to the change in control, the plan contains a provision granting such discretion. See Q&A-11 through 14.
- **Severance Plans.** Severance plans that do not cover key employees or that are not collectively bargained do not need to comply with Section 409A in 2005, so long as they are amended by December 31, 2005 to be compliant.

If you have any questions regarding the new guidance, or would like assistance in determining whether any participants in any of your nonqualified deferred compensation plans are entitled to make or change a deferral election before March 15, 2005, please do not hesitate to contact us.

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