ADAMS AND REESE LLP
LANGE SIMPSON

Volume 4 Issue 5 December 2004

Employee Benefits Bulletin

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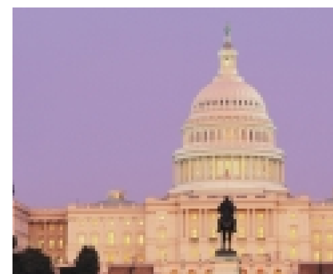
Congress Rewrites Rules for Non-Qualified Deferred Compensation Plans

Congress passed, and President Bush signed into law, the American Jobs Creation Act of 2004. Reading the media, one might think that this bill was stuffed with nothing but special-interest pork (and it certainly included a hefty serving of pork). But the Act also served up its share of baloney, pure junk food for the tax man. And the piece de resistance in this regard is Section 409A, which the Act adds to the Internal Revenue Code. Section 409A rewrites not only the rules for, but the very definition of, non-qualified deferred compensation plans.

Passed shortly before Halloween, and effective on January first of next year, Section 409A will be a New Year's nightmare for many businesses. For almost all business entities, it will mean reviewing compensation policies and for many businesses modifying those policies to conform to Section 409A's requirements. Fortunately, modification of plans can probably wait until next year (see Section 8 below).



Section 409A rewrites not only the rules for, but the very definition of, non-qualified deferred compensation plans.

What makes matters worse is that Section 409A, which replaces more than half a century of settled doctrine on non-qualified deferred compensation, is not a model of legislative clarity. The section includes ambiguous language and is of ambiguous scope; it will require the Department of Treasury to resolve numerous interpretive and policy issues. Congress realized this and directed the Department of Treasury to release guidance within 60 days of the Act's passage.

This means that guidance will be released by, and many people think no sooner than, December 21, 2004, which will not give businesses sufficient time to amend their deferred compensation plans before the new year. Almost everyone, however, expects the guidance to include generous transition relief, which will allow employers to defer making major amendments to their plans until 2005.

This article will describe the major provisions of and issues revolving around Section 409A. The last section describes what businesses should be thinking about and doing during this holiday season and next year.

1. Background and Historical Context

The tax treatment of participants in non-qualified deferred compensation plans has long been found in the intersection of administrative ruling, judicial holding, and statutory rules (primarily Internal Revenue Code Section 83). The three key overarching doctrines were those of constructive receipt, vesting, and economic

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benefit, which are briefly summarized below.

Under the constructive receipt doctrine, a person has tax liability for money to be paid in the future if he received it "constructively." Thus, if a person, *after* providing services, tells his employer to pay part of his compensation in a later year, the person often will have income in the year services were provided, notwithstanding the deferred receipt. If, on the other hand, the worker and employer agree to have some compensation deferred before the time substantial services are rendered, the deferred payments generally will be taxable income in the year actually received. Administrative rulings and case law filled in many details about when and how deferral elections had to be made, and different rules applied to bonuses and salary.

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Under the economic benefit doctrine, an individual recognizes income in the year in which he enjoys the economic benefit of property, even if it has not been legally transferred to him. Thus, for example, if the employer pays money into a trust to secure the employer's promise to pay deferred compensation for services already rendered, the employee will recognize income. In an important departure from this rule, the IRS has permitted the creation of the so-called rabbi trust (so named because its first reported use was by a temple who set up such a trust for its rabbi), which remains subject to the claims of creditors of the employer in the event of bankruptcy or insolvency.

Under the vesting doctrine, which is actually an offshoot of the constructive receipt rules, an employee does not recognize taxable income if deferred compensation is subject to a substantial forfeiture condition. Rather, the employee will have income only when the forfeiture condition is lifted. An important application of the vesting doctrine to relatively plain-vanilla non-qualified deferred compensation plans has been the so-called haircut rule. Assume for example that an employee had earned deferred compensation payable in two years, but that the employee had the right to accelerate the payment. The IRS has ruled that the ability to accelerate the payment will not result in constructive receipt if the acceleration resulted in a forfeiture of a substantial part of the deferred compensation. Moreover, the IRS required only a modest trim: a 10% forfeiture was considered sufficiently substantial to prevent constructive receipt.

Of course, this article is not intended to be a primer on the pre-Act rules on deferred compensation. Indeed, the pre-Act rules were quite complex and have been the subject of treatise writers. Nonetheless, the rules reflected well-established and clear core principles that resulted in predictable, and favorable, tax consequences for most deferred compensation arrangements.

So why did a generally business-friendly and tax-hostile Congress decide to rearrange the non-qualified deferred compensation landscape? There is, of course, no single answer. But the IRS has long questioned the favorable tax treatment of some deferred compensation arrangements and a law professor now at Harvard wrote an influential article several years ago suggesting that non-qualified deferred compensation arrangements were sufficiently tax favored that they threatened to undermine qualified deferred compensation plans. (The idea was that some of the incentive for a company to sponsor a qualified retirement plan is lost when executives can get favorable tax treatment for their deferred compensation through a non-qualified plan.)

But like so many recent reforms, thanks are owed primarily to the folks at Enron, whose executives used haircut provisions to accelerate payments from Enron's non-qualified plans. Thus, highly-paid Enron executives were able to withdraw substantial sums of their retirement money while rank-and-file employees could not. Many in Congress resolved to make certain that this would never happen again. Section 409A is their answer. Of course, Section 409A goes far beyond remedying the haircut issue and will affect the design of virtually every non-qualified deferred compensation plan in the nation.

2. An Expansive Definition of Deferred Compensation

Section 409A defines a nonqualified deferred compensation plan as any plan providing for the deferral of compensation, with certain express statutory exceptions. The statutory exceptions are a qualified employer plan and any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified plan includes employer plans subject to Sections 401(a), 403(a) or (b), 408(k) or (p), and 457(b) of the Internal Revenue Code.

This definition cuts a wide swath and pulls in plans that have not historically been subject to the same constructive receipt rules that have applied to what have traditionally been thought of as deferred compensation plans. Certain severance-pay plans, restricted stock and stock-perform-

ance based plans with income-deferral features (such as discounted stock options, stock appreciation rights, phantom stock, and discounted stock options), and other arrangements with deferral features are subject to the Section 409A rules. And of course the rules also apply to salary deferral plans, bonus deferral plans, SERPs, and private excess benefit plans.

The Secretary of the Treasury, however, has authority to prescribe regulations to exempt certain arrangements from Section 409A "if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors." The Conference Report indicates certain types of situations that are expected to be excluded from Section 409A's rules: (i) stock options issued with an exercise price equal to the fair market value of the option (unless the option includes a deferral feature after exercise); (ii) statutory options under Internal Revenue Code Section 422 (incentive stock options) or Section 423 (employee stock purchase plans); and (iii) certain plans that do not defer compensation for more than 2.5 months after the year in which related services are rendered.

It should be stressed that Section 409A rules apply to employees, independent contractors, and others (including directors) who are parties to a deferred compensation arrangement. Thus, for example, plans in which director fees are deferred are subject to Section 409A. Some people have noted that Section 409A may be extraordinarily difficult to apply to arrangements applicable to owner/employees of partnerships and limited liability companies.

It should be stressed that Section 409A rules apply to employees, independent contractors, and others (including directors) who are parties to a deferred compensation arrangement.

3. Timing Rules for Electing Deferral

Section 409A has two rules that govern the time by which a person can elect to defer compensation, a general rule and a rule for "performance-based compensation."

(i) The general rule provides that deferral must be made before the year in which the compensation is earned, or if later, within 30 days of when an employee first becomes eligible to participate in the relevant plan;

(ii) The special rule for performance-based compensation permits an election as late as six months before the end of the period for which the compensation is earned. For this rule to apply, the period on which the compensation is based must be at least one year long. The IRS will need to define what types of arrangements will be considered performance-based.

4. Distribution and Related Restrictions

It has been a common practice, especially with SERPs and excess benefit plans, for employees to be able to determine how to take a distribution at the end of the deferral period. This permits recipients to make the same election for their non-qualified and qualified plans benefits. Section 409A, however, essentially will end this practice by providing that distributions must be made only upon the occasion of one of the following six events: (i) death; (ii) disability (which the Act defines narrowly); (iii) change of control of the employer; (iv) an unforeseeable emergency (which cannot be met through other available financial resources); (v) a specified time or distribution schedule designated at the time of initial deferral; or (vi) separation from service.

A special rule applies to key employees (as defined under the rules for top-heavy plans) in publicly-traded companies: distributions have to be delayed until six months after a separation from service. It also is unclear what a separation from service will mean, and in particular whether it will include a "same-desk" rule. For example, will a person who retires but is then rehired as a part-time consultant, be considered to have separated from service? We can also expect regulatory guidance on other distribution issues, such as what is meant by a change in control.

Section 409A does permit a participant to change a distribution event (or to change the form of payment, e.g., from installment payments to a single lump sum payment), but only if certain restrictive conditions are met. The conditions are as follows:

(i) the new election cannot take effect for at least 12 months after the election is made;

(ii) except for distributions made on the occasion of death, disability, or unforeseeable financial emergency, the first payment under the election must be deferred for a period of at least five years from the date the payment would otherwise have been made; and

(iii) in the case of an election related to a specified time, the election must be made at least 12 months prior to the date of the otherwise first scheduled payment.

Note that the second requirement, at least if the statute is literally read, seems to make it impossible to change from an installment or annuity distribution to a lump sum distribution (except in cases of death, disability, or financial emergency).

The statute also makes it impermissible to accelerate payments. In other words, no haircuts, not even a crew cut.

5. Funded Arrangements

Section 409A also imposes some penalties on participants in funded non-qualified arrangements, if either of two circumstances occur: (i) if the trust invests in assets outside

the United States; or (ii) the assets become dedicated to funding benefits to the participant because of a change in the employer's financial health.

The full value of the trust will become income to the employee and the employee will pay penalties (described in the following section). In addition, it is possible that the mere existence of a financial health trigger will result in income taxation when the trust is established (under Section 83 or under other general tax law doctrine).

6. Penalties for Failure to Satisfy Section 409A Requirements

A participant who is affected by a plan's failure to satisfy a Section 409A requirement will recognize income equal to all previously deferred pay, plus a 20% penalty tax, plus interest (at the underpayment rate plus 1%) on the amount of underpayment that would have occurred if the deferred compensation were included in income at the time of deferral (or if later, when it became vested, i.e., was no longer subject to a substantial risk of forfeiture).

Note that the penalties apply regardless of whether the failure to satisfy Section 409A occurs because of defects in the plan language or because of operational defects.

7. Effective Date and Grandfather Rules

Section 409A is effective for deferrals made on or after January 1, 2005. Amounts deferred before then, and subsequent interest thereon, are not subject to Section 409A, unless the pre-2005 plan is materially modified after October 3, 2004. Transition guidance may, however, permit certain modifications. The Conference Report, however, makes clear that an acceleration of vesting, or the addition of a haircut provision, should be considered material modifications.

8. Things to Think About, Things to Do, Things to Think About Doing

What should businesses be doing –and not be doing – now? Here are some suggestions:

(1) Create an inventory of all arrangements and plans that might be affected by Section 409A. Note that this might include not only formal plans, but also provisions in contracts with individual employees and independent contractors. The list should probably also include all equity-based performance plans or contractual provisions. If in doubt about whether an arrangement will be subject to Section 409A, err on the side of including the arrangement in the inventory.

(2) Begin to determine what features of each arrangement might fail to satisfy Section 409A. Also begin to determine whether old plans should be frozen and new plans adopted (but see advice (5) below).

(3) Communicate with employees. Keep in mind that existing deferral arrangements are generally contractual and often cannot be changed in a way that restricts employee rights without the employee's consent. Even though transition guidance does not yet exist, it is probably not too early to let employees know of the possible effects of the legislation on their tax treatment.

(4) Consider encouraging all individuals covered by a nonqualified deferred compensation arrangement the opportunity to make a deferral election before January 1st, except for arrangements that are clearly performance-based. Consider amending plans that do not currently permit deferral decisions to be made that early.

(5) Be reluctant to modify existing plans or to adopt new plans until IRS guidance is released. Consider freezing an existing plan (although you should be sure a freeze does not accelerate vesting or have some other effect that will trigger the requirements of the new statute).

Most observers believe that the IRS guidance will provide flexibility to make necessary changes in the first half of 2005.

Most observers believe that the IRS guidance will provide flexibility to make necessary changes in the first half of 2005. Acting before such guidance is released is generally not advisable. Consult with an attorney before taking any of the above-mentioned actions.

9. Is there anything good about Section 409A?

Although Section 409A will create problems in the short-term and will reduce some employee and employer flexibility, it will at least result in generally simpler plan designs. We anticipate that the most negative effects of Section 409A will be on plans that use equity-measures for deferred bonuses. Here, IRS guidance will be critical in determining what the shape of stock-based plans will look like in the future.

In some ways, Section 409A parrots the structure of Section 401(a), which sets forth the requirements for qualified deferred compensation plans. Non-qualified plans, in order to capture favorable tax treatment, will now have to meet "qualification conditions," similar to the way qualified plans have to meet qualification conditions.

Let's hope that in the future we don't have to add to our vocabulary the terms "qualified nonqualified deferred compensation arrangements" and "nonqualified nonqualified deferred compensation arrangements."

No Such Thing as a Fee-Free Lunch

If you think about it, a 401(k) is really just a bundle of services, for which fees are charged and paid. A typical plan, for example, might purchase brokerage services, trustee services, legal services, investment management services, recordkeeping services, accounting services, information reporting services, retirement planning services, investment advice services, electronic information and transaction services, and other administrative services. In a sense, the plan is an intermediary, purchasing these services for its participants.

Sometimes the plan (or the employer maintaining the plan) pays a separately stated charge when it purchases a service. In such cases, it is obvious that the plan is paying for the services.

In other cases, however, the fund might not be charged directly for its services. For example, a mutual fund company might provide a plan with recordkeeping and other services without charge, so long as the plan requires participants to choose among the company's funds for their plan investments. But this does not, of course, mean that the service is actually provided for free. The mutual fund will set its asset management and other fees—which typically are a percentage of assets under management—sufficiently high to cover the cost of providing these services (and to make a profit).

Such a system, with bundled services purchased with a bundled fee, sometimes makes it difficult to assess whether a fund is being overcharged. Moreover, the "bundled fee" will rise as plan assets grow even if the provided services remain the same, since the bundled fee will grow proportionately to the growth in plan assets. Thus, what might have been a reasonable investment management fee in one year – given the services being provided – might be unreasonably high the next year.

A small difference in annual fees can make a significant difference in retirement income for plan participants. For example, assume two otherwise identical mutual funds, except that one fund has annual fees of 1% and the other 1.5%. An employee who invests in the lower-cost fund will have almost 15% more retirement income than an employee who invested in the higher-cost fund.

The Department of Labor has made it clear that a fiduciary responsible for selecting investments and purchasing plan services has to keep an eye on what services the plan needs and what fees it is being charged for those services, even when such fees are not separately stated. The plan fiduciary also has a continuing duty to monitor service and investment providers, including the fees they charge.

The Department of Labor has recently published a useful booklet on such fees, which should be required reading for such fiduciaries. The booklet, Understanding Retirement Plan Fees and Expenses, is available on line at the Department's website:

www.dol.gov/ebsa/publications/undrstndgrtmnt.html

TIDBITS

Phased Retirement. Consultants and policy wonks have recently been interested in "phased retirement," or allowing workers to gradually reduce their work schedule from full-time to retirement over a period of several years. This can be financially viable if the loss of work income could be replaced with the payment of income from the employer's pension plan. Long-standing treasury regulations governing pension plans, however, generally prohibit a pension plan from making payments to employees before they fully retire (or reach retirement age under the plan). The IRS has recently indicated that it would like to revisit those rules and permit, for example, an employee (over 59.5) who has reduced his work by 40% before retirement age to begin collecting pension income up to 40% of his normal benefit.

New Dependent Definition. The Working Families Tax Relief Act of 2004 ("WFTRA") amends the definition of dependent under Section 152 of the Internal Revenue Code. A technical and conforming amendment avoids changing the definition of dependent for purposes of Section 105(b) (excluding reimbursements for medical care), but there is not (yet, at least) a similar conforming amendment for Section 106(a) (excluding health care coverage). IRS Notice 2004-79 indicates that the IRS intends to revise the regulations under Section 106 to avoid changing the definition of dependent for purposes of Section 106. Nevertheless, health care plans that provide benefits to dependents should be reviewed in light of the changes, along with other benefit plans that reference dependents (such as 401(k) plans with safe harbor hardship provisions, or unforeseeable emergency distributions under Section 457 or other deferred compensation plans).

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We will try to address your question or topic in a future newsletter.

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