

NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS

Effective Date for Compliance Delayed

By Bruce Ashton

Since late 2004, Internal Revenue Code section 409A has imposed new rules on nonqualified deferred compensation arrangements, including both operational and “form” requirements. However, even though the new law applies to compensation that is deferred after December 31, 2004, the IRS has again delayed the date by which plans must be amended to comply with the form requirements of the law. (In this context, when we refer to “deferred compensation,” we mean not only pay that an employee elects not to receive currently but also amounts that an employer agrees to pay to the employee in future years.)

For most of this year, we’ve been working towards a December 31, 2006, deadline for modifying plan documents. But the IRS now says we can wait another year (until December 31, 2007) to change our documents. This is to give IRS and Treasury time to finalize the guidance on the new law. Nevertheless, nonqualified deferred compensation arrangements must still be operated under a reasonable, good faith interpretation of the law, as they have since the beginning of 2005, even if the document under which they are created has not been amended to comply with section 409A.

In general, this means that, even if the plan document does not specifically so state:

- deferral elections must be made before the beginning of the tax year in which the income to be deferred is earned (except for “incentive based compensation” and deferral elections may be made within the first 30 days after an employee first becomes eligible to participate in a plan);
- benefits may be distributed only on death, disability (as defined in the law), termination of employment, retirement, change in control (as defined in the law), financial hardship (subject to

severe limitations) or at a specified date elected by the employee – thus, provisions that have permitted employees to make a current election to receive a distribution subject to a penalty (sometimes referred to as “haircut provisions”) are eliminated;

- distributions to “key employees” of public companies on termination or retirement must be delayed six months from the date of termination of employment;
- participants may not elect to accelerate their distributions (which would include a change in the form of distribution from, say, payment in installments over 10 years to payment in a lump sum); and
- participants may not elect to delay their distributions unless the election is made at least 12 months in advance of the original distribution date and the delay in the distribution is for at least 5 years.

As to the last point, however, in its recent announcement, the IRS says that participants may make changes in the time and form of payment so long as the plan so provides and the election is made before December 31, 2007. This would not permit a participant who to change his or her election for the current year, but it would permit the participant to make a change for a distribution to be made later on without complying with the 5 year rule noted in the last bullet. For example, if a participant had elected in 2005 to take a distribution in 2007, under this exception, he or she could not make an election in 2007 to delay the distribution to 2008 or later. But the participant could elect to defer a distribution scheduled for 2008 until 2010 (so

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long as the election was made 12 months or more before the scheduled distribution date in 2008).

Section 409A directed IRS and Treasury to issue regulations to fill in gaps in the law. Roughly a year ago, proposed regulations were issued that addressed these gaps and also questions on how to interpret the statute in various specific contexts. IRS and Treasury promised more guidance on remaining open issues (for example, there are still a number of issues related to various forms of employer stock-based deferred compensation) in 2006. It's now clear that the regulations will not be finalized and that the additional guidance won't be out soon (in part, we suspect, because of the adoption of the Pension Protection Act of 2006 in mid-August).

In the recent release, IRS said that for now, nonqualified arrangements need not comply with provisions of the proposed regulations (at least insofar as they expand on or explain the Code section), but they said that following them would be viewed as "reasonable, good faith" compliance with the law. In other words, you don't have to follow the requirements of the proposed regulations in areas not specifically addressed in the statute; but you do have to comply with the law and if you follow the interpretations in the proposed regs, this will keep you from being questioned later on.

Finally, under section 409A, elections for distributions from a qualified plan and a nonqualified plan cannot be linked. This happens, for example, if a nonqualified plan

provides that the participant will receive a distribution in the same form as that elected under the company pension plan. In a qualified plan, the participant makes the election regarding the form and timing of distributions after there is a "distributable event," but as noted, this cannot occur in a nonqualified arrangement. The IRS notice relaxes this rule through the end of 2007.

What do we recommend? Unless your plan has stock-based elements, we suggest that you complete the amendment process now rather than waiting. Most of the issues for the simple deferral-with-company-match arrangements have been answered in existing guidance, and we think it is unlikely that any new guidance will fundamentally change the terms of the arrangement in the future. There is a slight risk that a further amendment to the document would have to be made, but we believe that in most plans, this won't be the case.

If we can help, please call us at (310) 478-5656.

Fred Reish (fredreish@reish.com)
Bruce Ashton (bruceashton@reish.com)
Debra Davis (debradavis@reish.com)
Stephanie Bennett (stephaniebennett@reish.com)

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