

NONQUALIFIED DEFERRED COMPENSATION & CODE §409A

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I. REVIEW OF NQDC PRIOR TO CODE §409A

- A. Nonqualified Deferred Compensation (“NQDC”) Plan - a plan, agreement, or arrangement between an employer and an employee (or service recipient and service provider) to pay compensation in the future.

- B. Do not have all of the tax benefits associated with qualified plans (do not satisfy all of the requirements of Code §401(a); must follow “matching” concept). NQDC plans typically fall into several categories:
 - 1. Salary Reduction Arrangements - defer receipt of otherwise currently includible compensation by allowing deferral of receipt of salary.
 - 2. Bonus Deferral Plans - resemble salary reduction arrangements.
 - 3. Top-Hat Plans (or Supplemental Executive Retirement Plans or SERPs) - provide benefits to employees whose benefits under a qualified plan are limited (e.g., by Code §415).
 - 4. Phantom Stock Plans - typically are NQDC arrangements (as opposed to stock arrangements).

- C. Funded or unfunded?
 - 1. Most NQDC plans are intended to be unfunded because of the tax advantages associated with “unfunding”.
 - a. “Unfunded” - the employee has only the employer’s “mere promise to pay” the deferred compensation benefits in the future.

- b. The benefit can be tracked in a bookkeeping account or it could be invested (e.g., in annuities, securities, or insurance arrangements).
- c. The benefit could be transferred to a trust (but keep as part of employer's general assets subject to the claims of the employer's creditors if the employer becomes insolvent).
- d. To obtain the benefit of income tax deferral, the amounts are not set aside from the employer's creditors for the exclusive benefit of the employee.
- e. Rabbi Trust - intended to work for a top-hat or excess benefit plan (simply allows money to go to a trust without being deemed "funded" and causing constructive receipt).

Why called "Rabbi Trust"?

- 2. If amounts are set aside from the employer's creditors for the exclusive benefit of the employee, the employee may have currently includible compensation.
 - a. A funded arrangement generally exists if assets are set aside from the claims of the employer's creditors (e.g., a qualified retirement plan).
 - b. "Funded" - if assets are segregated or set aside so that they are identified as a source to which participants can look for the payment of their benefits.
 - c. The relevancy is whether the employee has a beneficial interest in the assets (not necessarily whether the assets have been identified as belonging to the employee).
 - d. Funded - likely taxable under Code §§83 and 402(b).

D. Constructive Receipt Concept

1. Generally - cash basis taxpayers must take items into gross income in the taxable year in which they are actually or constructively received.
2. Constructive Receipt - although not actually reduced to a taxpayer's possession, income is "constructively received" when it is credited to the employee's account, set apart for the employee, or otherwise made available so that it may be drawn upon at any time (or so that it could have been drawn upon during the taxable year if notice of intention to withdraw had been given). (See Code §451(a).)
3. No constructive receipt if taxpayer's control of receipt is subject to substantial limitations or restrictions. (See Reg. §1.451-2(a).)
4. Inquiry: did the taxpayer have control of the receipt of the deferred amounts so that such control was not subject to substantial limitations or restrictions?
5. Scrutinize all plan provisions relating to each type of distribution or access option.
6. Must consider the NQDC plan's operation regardless of the existence or form of written provisions.
7. Permitting borrowing against deferral amounts can cause constructive receipt.

E. Economic Benefit Concept

1. Generally - if an individual receives any economic or financial benefit or property as compensation for services, the value of the benefit or property is currently includible in gross income.

2. Employee must include in current gross income, the value of assets that have been unconditionally and irrevocably transferred as compensation into a fund for the employee's sole benefit, if he/she has a nonforfeitable interest in the fund.
3. If property is transferred to a person as compensation for services, taxation will occur at the time of receipt of the property if the property is either transferable or not subject to a substantial risk of forfeiture. (See Code §83.) If the property is not transferable and subject to a substantial risk of forfeiture, no income tax is incurred until it is not subject to a substantial risk of forfeiture or the property becomes transferable.
4. "Property" - includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future (and also includes a beneficial interest in assets, including money, transferred or set aside from claims of the creditors of the transferor (e.g., in a trust or escrow account)).
5. Substantial Risk of Forfeiture - property is subject to a "substantial risk of forfeiture" if the individual's right to the property is conditioned on the future performance of substantial services or on the nonperformance of services.
 - a. S.R.O.F. - if entitlement to the amount is conditioned on the performance of substantial future services (or the occurrence of a condition related to a purpose of the compensation) and the possibility of forfeiture is substantial. A condition related to a purpose of the compensation must relate to the employee's performance for the employer or the employer's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event).

- b. Is the possibility of forfeiture substantial? If employee owns a significant amount of the total combined voting power or value of all classes of stock of the employer or of its parent corporation, there will be taken into account:
 - i. The employee's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation;
 - ii. The position of the employee in the corporation and the extent to which the employee is subordinate to other employees;
 - iii. The employee's relationship to the officers and directors of the corporation;
 - iv. The person(s) who must approve the employee's discharge; and
 - v. Past actions of the employer in enforcing the restrictions.
 - c. S.R.O.F. could exist if the right to the property is subject to a condition other than the performance of services and there is a substantial possibility that the property will be forfeited if the condition does not occur.
6. "Transferable" - if the interest in the property can be transferred to anyone other than the transferor from whom the property was received. Not "transferable" if the transferee's rights in the property are subject to a substantial risk of forfeiture.

- F. Cash Equivalency Concept
 - 1. A promise is the equivalent of cash and taxable as such if the promise to pay is unconditional and assignable, not subject to set offs, and is of a kind that is frequently transferred to lenders or investors at a reasonable discount.
 - 2. If the right to receive future payment is reduced to writing and is transferable (e.g., a note or a bond), the right is considered to be the equivalent of cash and the value of the right is gross income.
- G. Pre-Code §409A - payment of NQDC can be accelerated on specific events or at any time if early payment is subject to a penalty (a.k.a. a "haircut") or other substantial restriction.
- H. Is arrangement subject to ERISA?
 - 1. Is it a "plan"?
 - 2. Is there an applicable exception? (e.g., if a top-hat plan for "select group of management or highly compensated employees", it is exempt from parts 2, 3, 4 of Title I of ERISA).
- I. FICA
 - 1. Generally imposed at the later of when the services are performed or when there is no "substantial risk of forfeiture".
 - 2. Could be at the time of deferral, unless substantial services are required to be performed in order for the employee to have a legal right to future payment. If the employee is required to perform future services in order to have a vested right to the future payment, the deferred amount (plus earnings to the date of vesting) is subject to FICA when all of the required services have been performed. (Is there a vesting schedule in the plan?)

3. Contrast with income tax - usually imposed when distributed (assuming no constructive receipt earlier).

J. FUTA

1. Generally imposed at the later of when the services are performed or when there is no “substantial risk of forfeiture”.
2. See FICA information.

K. SECA – similar to income tax applications

L. IRS Suggested Audit Inquiries

1. Does the employer maintain any qualified retirement plans?
2. Does the employer have any plans, agreements, or arrangements for employees that supplement or replace lost or restricted qualified retirement benefits?
3. Does the employer maintain any nonqualified deferred compensation arrangements, or any trust, escrows, or separate accounts for any employees?
4. Do employees have individual employment agreements?
5. Do employees have any salary or bonus deferral agreements?
6. Does the employer have an insurance policy or an annuity plan designed to provide retirement or severance benefits for executives?
7. Are there any minutes or board of directors or compensation committee resolutions involving executive compensation?

8. Is there any other communication between the employer and the employees that sets forth the “benefits,” “perks,” “nonqualified savings,” “severance plans,” or “retirement arrangements”?

M. IRS Suggested Audit Steps

1. Interview company personnel that are most knowledgeable on executive compensation practices, such as the director of human resources or a plan administrator.
2. Determine who is responsible for the day-to-day administration of the plans within the company. For example, who processes the deferral election forms and maintains the account balances?
3. Review the deferral election forms and determine if changes were requested and approved.
4. Review the executive compensation disclosures in SEC filings (e.g., proxy and exhibits to Form 10-K – use Edgar search for filings?). Review financial statement notes. If stockholders vote for a compensation plan, the proxy will contain detailed disclosure on the plan and the plan should be attached as an exhibit.
5. Determine whether the company paid a benefits consulting firm for the executives’ wealth management. Review a copy of the contract between the consulting firm and the corporation. Determine who is administering the plan. Determine what documents are created by the administrator and who is maintaining the documents.
6. Review the ledger accounts/account statements for each plan participant, noting current year deferrals, distributions, and loans. Compare the distributions to amounts reported on the employee’s W-2 for deferred compensation distributions. Determine the reason for each distribution. Check account statements for any

unexplained reduction in account balances. Any distributions other than those for death, disability, or termination of employment need to be explored in depth.

7. Matching Concept

a. The employer's deduction must match the employee inclusion of the compensation in income. The employer must be able to show that the amount of deferred compensation it deducted matches the amount it reported on the Forms W-2.

b. The employer's deduction may be limited by Code §162(m).

8. Was a Schedule M-1 adjustment was made to the Form 1120 (for deferred compensation amounts that are expensed on the employer's books but that are not deductible because they are not includible in employee income)?

II. CODE §409A (Prior to Issuance of Proposed Regulations)

A. Generally

1. If a NQDC plan fails to meet Code §409A (or is not operated in accordance with it), all amounts deferred for the taxable year and all preceding taxable years (by any participant with respect to whom the failure relates) are includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

2. The application of other concepts are unaffected (e.g., deferred compensation not required to be included in income under Code §409A may be required to be included in income under Code §451, the constructive receipt doctrine, the cash equivalency doctrine,

Code §83, the economic benefit doctrine, the assignment of income doctrine, etc.).

B. Definition of NQDC plan

1. In general - any plan that provides for the deferral of compensation.
2. Not limited to arrangements between an employer and an employee (e.g., may apply to arrangements between a service recipient and an independent contractor, or arrangements between a partner and a partnership).

C. What is a deferral?

1. Generally – if the employee has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and is payable in a later year.
 - a. There is no legally binding right to compensation if it may be unilaterally reduced or eliminated by the employer after the services have been performed (but, if the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or the discretion is unlikely to be exercised, the employee will have a legally binding right to the compensation).
 - b. A deferral does not occur solely because compensation is paid after the last day of the employee's taxable year pursuant to the timing arrangement under which the employer normally compensates employees for services performed during a payroll period (see Code §3401(b)).

2. Assuming no election to further defer, a deferral does not occur if the NQDC plan requires payment (or actual or constructive receipt occurs) by the later of:
 - a. 2-1/2 months from the end of the employee's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or
 - b. 2-1/2 months from the end of the employer's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

Additional guidance?

D. Consequences of Noncompliance

1. All deferred compensation is includable in gross income to the extent that the compensation is not subject to a substantial risk of forfeiture.
2. Interest payable at the underpayment rate plus one percentage point.
3. 20% penalty on the amount required to be included in income.
4. If the applicable requirement affects only some of the plan participants, then current income inclusion, interest, and the additional tax apply only to those participants.

E. Deferrals

1. Initial deferral elections must be made in a year before the year in which the related services are performed.
2. Are deferral elections "irrevocable"?

3. Bonus Compensation

- a. Elections for performance-based compensation (based on services performed over a period of at least 12 months) must be made no later than 6 months before the end of the service period.
- b. Generally, performance-based compensation is compensation that is:
 - i. Variable and contingent on the satisfaction of pre-established organizational or individual performance criteria, and
 - ii. Not readily ascertainable at the time of the election.

Additional guidance?

- c. The requirements are intended to be similar to those in Code §162(m).

F. Distributions

- 1. NQDC generally cannot be distributed earlier than:
 - a. Separation from service (6-month waiting period for any separation from service distribution to a key employee of a publicly traded company);
 - b. Death;
 - c. Disability;
 - d. An unforeseeable emergency;
 - e. A specified time; or

- f. Under a fixed schedule.
- 2. Acceleration of distributions not allowed (except as provided by regulations).
- 3. Distribution may be permitted upon the occurrence of a “change in the ownership,” a “change in effective control,” or a “change in the ownership of a substantial portion of the assets” of the corporation (as provided by regulations).
 - a. Relevant corporations - to constitute a change in control event as to the plan participant, the change in control event must relate to:
 - i. The corporation for whom the participant is performing services at the time of the change in control event.
 - ii. The corporation that is liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable).
 - iii. A corporation that is a majority shareholder of a corporation identified in (i) or (ii), or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in (i) or (ii).
 - b. See Code §318(a) (attribution for stock ownership).
- 4. An election can be made to delay the timing or change the form of distributions (but such an election cannot take effect for at least 12 months and must be made at least 12 months before the first scheduled payment).

5. Re-deferrals - an additional 5 years.

G. Plans Affected

1. NQDC plans with employer contributions, salary deferrals, SARs, and non-statutory stock options granted "in-the-money".
2. N/A to qualified plans, bona fide vacation leave plans, compensatory time, disability pay plans, death benefit plans, NSOs not granted "in-the-money", Code §422 ISOs, Code §423 ESPPs, and Code §457(b) arrangements.

H. Effective Date

1. Effective for amounts deferred in tax years beginning after 12/31/04.
2. Amounts deferred in tax years beginning before 2005 would be affected if the plan is "materially modified" after 10/3/04 (a material modification would generally be the addition of a benefit, right or feature or the modification of a pre-existing one).
3. IRS guidance for plans adopted by 12/31/04? (to provide a limited period in which the plan):
 - a. Can be amended to permit termination of participation or cancellation of outstanding deferral elections, or
 - b. Can be amended to conform to the new law for amounts deferred after 2004.

I. Stock Options, SARs, Etc.

1. The grant of a stock option, SAR or other equity-based compensation unit can provide for a Code §409A deferral of compensation.

2. SARs generally will be covered by Code §409A, but may be structured for compliance (e.g., using an SAR with a fixed payment date).

J. Nonstatutory Stock Options

An option to purchase stock of the employer (other than an ISO described in Code §422 or an option granted under a Code §423 Employee Stock Purchase Plan), does not provide for a deferral of compensation if:

1. The amount required to purchase stock under the option (the exercise price) may never be less than the fair market value of the underlying stock on the date the option is granted;
2. The receipt, transfer or exercise of the option is subject to taxation under Code §83; and
3. The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option (see Reg. §1.83-7).

K. Statutory Stock Options

The grant of an ISO (or a Code §423 ESPP option) does not constitute a deferral of compensation.

L. SARs

No “deferral” for an SAR with respect to the employer’s stock if:

1. The value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted;

2. The stock of the employer subject to the right is traded on an established securities market;
3. Only such traded stock of the employer may be delivered in settlement of the right upon exercise; and
4. The right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

M. Restricted Property

1. If employee receives property from a NQDC plan, there is not necessarily a “deferral” merely because the property is not includible in income yet because the property was not transferable and subject to a substantial risk of forfeiture (or is includible in income solely due to a valid election (see Code §§83 and 83(b))).
2. If employee has a legally binding right to receive property (whether or not it is restricted property) in a future year, this may provide for a “deferral” of compensation (and the arrangement may constitute a NQDC plan).

N. Earnings

References to the deferral of compensation include references to the attributable income (whether actual or notional).

O. Revisiting Plan Constitution after Code §409A

1. NQDC Plan - any agreement, method, or arrangement, including one that applies to one person or individual.
 - a. May be adopted unilaterally by the employer or may be negotiated with the employee.

- b. May constitute a plan regardless of whether it is an employee “benefit plan” under ERISA §3(3).
- 2. Generally, the requirements of Code §409A are applied as if:
 - a. A separate (plan or plans) is maintained for each employee;
 - b. All compensation deferred with respect to an employee under an account balance plan is treated as deferred under a single plan;
 - c. All compensation deferred under a nonaccount balance plan is treated as deferred under a separate single plan; and
 - d. All compensation deferred under a plan that is neither an account balance plan nor a nonaccount balance plan (for example, discounted stock options, stock appreciation rights or other equity-based compensation is treated as deferred under a separate single plan).

III. ACTIONS GOING FORWARD

A. Review Existing Plans

- 1. Perform review well prior to year-end
- 2. Pay particular attention to deferral elections and distribution provisions
- 3. Standard review of provisions should at least include:
 - a. Are initial deferral elections required to be made no later than the close of the year prior to the year during which the services giving rise to the compensation are performed?

- b. If the plan is new or there is a new participant, does the plan require those deferral elections to be made within 30 days (i.e., a 30-day grace period) of initial eligibility for prospectively-earned compensation?
- c. Does the plan require that a deferral election with respect to “performance-based compensation” be made no later than 6 months before the end of the service period (if the service period is at least 12 months)? How does this interact with elections on annual and L-T bonuses that do not qualify as "performanced-based compensation" and bonuses paid within 2-1/2 months after the close of the taxable year in which the services are performed?
- d. Is the deferral election irrevocable?
- e. Does the plan permit distributions only upon the following events (is plan termination a permissible distribution event?):
 - i. Separation from Service (How does this interact with a former executive who continues to provide services in a consulting relationship?);
 - ii. Death;
 - iii. Disability

Does the definition of “disability” in the plan meet the definition under the law/regulations? (Generally, this is expected to mean that by reason of any medically determinable physical or mental impairment which can be expected to result in death or expected to last for a continuous period of not less than 12 months, the participant (a) is unable to engage in any

substantial gainful activity, or (b) is receiving income replacement benefits for a period of not less than 3 months under an accident or health plan of the employer).

- iv. As necessary to meet an unforeseeable emergency (generally, means a severe financial hardship resulting from an illness or accident of the participant (or his or her spouse or dependents) beyond his or her control - as long as the amount provided does not exceed that which is necessary to relieve the financial burden);
- v. At a specific time or pursuant to a fixed schedule in the plan as of the date of deferral (amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time (e.g., a child beginning college is not a specified time));
- vi. Change in Control

If a distribution is permitted upon a change in control, does the definition of "change in control" in the plan meet the definition under the law/requirements (so far, perhaps could be comparable but more restrictive/no broader than the definition used for Section 280G golden parachute arrangements)?
- vii. Are the time and form of distributions required to be designated by the plan at the time of the initial deferral election?

- f. If the plan allows for any changes that delay or change the form of payment, are the following requirements met:
- i. Is the change not effective until at least 12 months after the date on which the election change is made (i.e., the second election may not be given effect for at least 12 months)?
 - ii. Is the payment with respect to which the change is made deferred for at least 5 years from the date that the payment would otherwise have been made if the payment is made due to separation from service, a specified time (or pursuant to a fixed schedule), or following a change in control (i.e., except in the case of death, disability, or an unforeseeable emergency)?
 - iii. Is the change not permitted to be made less than 12 months before the date of the first scheduled payment if the change relates to a payment made on account of a specified time (or pursuant to a fixed schedule) (i.e., the second election must be made at least 12 months before the originally scheduled payout date (if a specified date))?
- g. Does the plan disallow the acceleration of the time or schedule of payments except as provided in the Regulations? (Prior to the issuance of guidance, this generally means no accelerations of distribution payments except upon change in control, death, disability, or unforeseeable emergencies, domestic relations orders, certificates of divestiture, to pay income taxes in a 457(f) plan, for less than \$10,000 cash outs (with certain requirements), or to pay employment taxes. Basically,

eliminates haircut provisions to provide in-service distributions with a penalty (at least with respect to ungrandfathered dollars). Also, a change in the form of distribution that accelerates payments (e.g., from installments to lump sums) will be subject to the rule prohibiting acceleration. Will provisions permitting the employer to unilaterally accelerate the distribution on the occurrence of certain events, including termination of the plan or the participant ceasing to be part of the eligible top-hat group, need to be eliminated?)

- h. Are there automatic cash-out provisions for distributions?

The impact of this is unclear, but it is anticipated that the Regulations will provide that upon a separation from service (other than for key employees), account balances that are less than \$10,000.00 can be automatically distributed.

- i. Is the distribution election tied to qualified plan payments?

Keep provision or restructure?

- j. Does the plan provide for exercise rights (such as SARs and discounted stock options)?

Is the participant required to designate the exercise date up front?

- k. Does the plan include a domestic rabbi trust? If so, check to see that:

- i. There is no funding trigger for the plan that is tied to a “change in the employer’s financial health” (which will be subject to current taxation as a Section 83 transfer of property (even if the assets can be reached by the

company's general creditors)) (i.e., vested participants will be currently taxable to the extent that assets will become restricted to the provision of benefits in connection with a change in the employer's financial health (applies even where subject to claims of creditors), but this provision is not intended to apply when assets are restricted for a reason other than a change in financial health (e.g., a change in control) or if assets are periodically restricted under a structured schedule and the scheduled restrictions happen to coincide with a change in financial status); and

- ii. The rabbi trust is not a foreign or offshore rabbi trust (if so, see applicable rules).

B. New Plans

1. Observe all issues and rules previously applying to NQDC plans and new Code §409A
2. Discuss available option and plan designs with client (post-Code §409A)

C. Reporting

1. Use Forms W-2 or 1099-MISC
 - a. Code Y – for amount of deferral in current plan year
 - b. Code Z – for amount includible in income due to Code §409A violation

D. Transitional Issues

1. Understand grandfathered amounts – portion of an account balance plan earned and vested as of December 31, 2004
2. Beware of “material modifications”
 - a. Plan amendment to bring it into compliance with Code §409A will not be a “material modification”?
 - b. Can a pre-10/3/04 right be exercised for pre-1/1/05 deferrals?
 - c. Can amend to stop future deferrals?
 - d. Amend to terminate and distribute?
3. Pre-12/31/05 Plans – could amend during 2005 to terminate participation or deferral election (gross income when earned and vested)?
4. Good Faith Amendments – use amendments on or before 12/31/05 to comply if good faith compliance with Code §409A and Notice 2005-1.

IV. PROPOSED REGULATIONS

The IRS released Proposed Regulations as this summary was being prepared for printing. The Proposed Regulations are lengthy, detailed and expand on many of the issues created by the guidance reference above. At this point, it is our understanding that although the Proposed Regulations provide an additional time period for general compliance amendments, other time periods for transitional rules have not been extended (e.g., the deadline for certain elections to terminate plan participation or cancel deferral elections). Thus, it will still be necessary to review plans prior to December 31, 2005 and leave ample time for adjustments.

