Back Search Contents

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Analysis & Perspective

Executive Compensation

SERPs and Elective Deferral Plans Must Comply With §409A

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EXECUTIVE COMPENSATION

Section 409A of the Internal Revenue Code subjects all deferred compensation plans to strict rules governing the timing of payouts and elections, effective Jan. 1, 2005. Treasury guidance under Notice 2005-1 permits employers to defer documentary compliance until Dec. 31, 2005, but operational compliance is required immediately, with only limited transition relief. This article is a step-by-step guide for determining how to handle supplemental executive retirement plans (SERPs) and elective deferral plans under Notice 2005-1.

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SERPs: The Penalty Problem

Plan failure to comply with §409A subjects nongrandfathered deferred compensation under the "plan" to taxation, plus interest on the tax imputed since the compensation's vesting date, plus an additional tax equal to 20 percent of the compensation. For long-standing vested accruals under a supplemental executive retirement plan (SERP), imputed interest alone could double the tax penalty of failure.

IRS Notice 2005-1 magnifies penalty exposure. Notice 2005-1 magnifies the penalty exposure for SERPs and elective deferral plans, by inventing a new aggregation rule to define the failed plan. For penalty purposes, the plan is every nonqualified deferred compensation promise of the same type covering the same individual. Plan types are defined as account balance (defined contribution-type), nonaccount balance (defined benefit-type), and other (typically, equity-based) plans.

For example, consider an executive with $1 million in vested deferrals under a defined benefit SERP, who is also covered by a de minimis plan subject to §409A, such as a reimbursement agreement for tax-return preparation fees. (See "*Executive Employment Agreements Must Comply With §409A*," 25 PBD, 2/8/05.) Because both are defined benefit-type plans covering the same individual, the SERP benefit and the reimbursement agreement are the same "plan." The $1 million SERP benefit is vulnerable to tax plus imputed interest, plus a 20 percent penalty, upon any §409A failure in the reimbursement agreement.

Action Items

(1) Consider Exit Strategies. Some employers are considering an exit from the deferred compensation business. New §409A makes these plans less attractive to employees, because of its limits on acceleration, and harsh tax penalties for failure. While the tax penalties fall on the employee, many employers are worried about their exposure to liabilities to indemnify participants for tax penalties caused by the company's own mistakes.

(a) *Terminate the plan*. You can terminate your plans and distribute benefits to participants in 2005 without penalty, both for grandfathered and nongrandfathered benefits.

For *grandfathered benefits*, you can terminate the plan and force out amounts in 2005. After 2005, distribution incident to plan termination is a "material modification" that blows up the grandfather. *Nongrandfathered* benefits also can be forced out for a limited period. Some nongrandfathered benefits will not be vested in 2005. Vesting can be accelerated (acceleration of vesting is not a §409A violation), and amounts distributed in 2005. Or amounts can vest as originally scheduled, and be forced out later, in the first year they vest. A force-out of these amounts after 2005 (or after the first year they vest, if later) will generally violate §409A.

(b) *Freeze the plan at its grandfathered level--at least for now*. You can also "freeze" your plan at its grandfathered level. Under this approach, your plan would be maintained only for grandfathered benefits and would not permit any benefits subject to §409A, including any new accruals or nongrandfathered old accruals. It is not too late to take this course. Any nongrandfathered benefits can be forced out without penalty in 2005 (or the first year they vest, if later), as described in (a) immediately above.

As a middle ground, you may wish to take this course only temporarily, until Treasury issues more guidance. As a permanent strategy, freezing your plan at its grandfathered level may offer only limited protection. Unwittingly triggered "material modifications" can blow up the grandfather--and then you are back in the §409A compliance mess.

(c) *Allow opt-out elections*. Even if you are not ready to terminate the plan, participants may want to get out of any nongrandfathered deferral elections subject to §409A. For old nongrandfathered amounts, this is easy. You can allow participants to cash-out their benefits on an elective basis in 2005 (or the first year they vest, if later).

For grandfathered amounts, allowing elective opt-outs is harder. All individuals covered by the grandfathered arrangement who do not take advantage of the elective opt-out will be thereafter subject to §409A. Elective opt-outs of grandfathered amounts is thus a poor strategy unless you want to forego your grandfather altogether (discussed at (3) below).

(2) Consider Indemnifying Participants. Companies may want to provide--or participants may insist on--indemnification for tax penalties caused by company mistakes. Remember that any indemnification promise can itself be subject to §409A. For any existing agreements that are grandfathered, adding an indemnification provision will not itself blow up the grandfather--but the indemnification promise is of course not grandfathered.

(3) Manage Your Grandfather Protection.

(a) *Decide whether to keep grandfather*. Keeping the grandfather has pros and cons:

- *Pros: limiting penalty exposure*. The biggest advantage of the grandfather is tied to the penalty provisions of §409A. As we have noted, a violation of *any* deferred compensation plan subject to §409A triggers taxation, plus interest imputed back to the vesting date, plus an additional 20 percent tax, on all deferred compensation under all plans of the same type covering the same individual. For longstanding accruals, like those in SERPs and elective deferred compensation arrangements, imputed interest on the tax could itself be significant. Grandfathered benefits are not subject to penalties, even for failures of nongrandfathered benefits in the same plan, or for plans of the same type.

- *Cons: long term administrative hassle*. Keeping the grandfather may be complicated, however. First, it requires accounting separately for two "buckets" of compensation--grandfathered, and nongrandfathered. Second, the grandfather protection will be blown up if the sponsor commits an inadvertent "material modification" of the plan. For example, your administrator might mistakenly allow a payout not allowed under the terms of the plan. Legislative history suggests that operational failures might be viewed as de facto plan modifications. Third, Treasury officials are debating amongst themselves whether a decision to administer benefits under the grandfather should be irrevocable. During a recent teleconference, most Treasury staff appeared to reject the irrevocability approach--but you should be aware that it is being debated.

- *Make sure your plan permits forfeiture*. Before you forfeit the grandfather, first determine whether this is permitted under the terms of the plan. Many plans contain anti-cutback restrictions that prohibit plan amendments that reduce plan "benefits." It is not always clear whether "benefits" for this purpose includes optional payout forms. Depending on how your anti-cutback provision is drafted, you may be stuck with maintaining the grandfather for pre-2005 vested deferrals.

(b) *Identify and prepare to track grandfathered amounts*. If you decide to protect the grandfather for pre-2005 vested benefits, you must identify grandfathered amounts. For defined contribution-type plans, the grandfathered amounts include the Dec. 31, 2004, balance, together with future earnings on that amount. For defined benefit-type plans, the grandfathered amount is the present value of the benefit the participant would have received if the participant had terminated employment on Dec. 31, 2004. The grandfathered amount in a defined-benefit type plan does not include the value of an early retirement subsidy that the employee might grow into in the future.

(c) *Avoid a "two plan" strategy for grandfathered amounts*. Some employers have considered protecting grandfathered benefits by confining them to a separate plan and creating a "new" plan for nongrandfathered and new accruals. This may not be advisable. Some transition relief is available only for plans in existence before 2005 (see 5(a) and (6) below). This relief is thus unavailable for the new plan in the two-plan strategy. At best, the two-plan strategy is unnecessary. Violations of nongrandfathered deferrals won't trigger penalties of grandfathered deferrals, whether or not in the same plan document.

If you have already adopted the two-plan approach, and want to undo it, it is not too late. You can amend the new plan to place benefits back into the old, grandfathered plan. This is not a material modification and does not blow up your grandfather protection.

(4) Defer Making Long-Term Design Decisions Until Later This Year. Do not rush into plan designs affecting payout or deferral decisions that will be made after 2005. (For payout and deferral elections that must take place this year, see (5) and (6) below). Key points of the new law are as yet undecided by Treasury guidance. It might make sense to wait until the rules become clearer.

(5) Prepare for Participants Who Enter Pay Status in 2005. Some participants will go into pay status in 2005--for example, participants who terminate employment this year.

(a) *Grandfathered benefits*. Allow participants to elect payouts allowed under the terms of the plan for grandfathered benefits in 2005.

(b) *Payout elections linked to qualified plan elections* are allowed in 2005, if already allowed by the plan as of Oct. 3, 2004. Payouts even of nongrandfathered benefits made pursuant to these 2005 piggyback elections do not have to conform with the payout rules of §409A (e.g., they do not have to conform with the six-month rule for key employees).

(c) *Payout elections for other nongrandfathered benefits*. For other nongrandfathered benefits, Notice 2005-1 offers two ways to structure payout elections in 2005-1:

- *Payout elections in 2005*. Notice 2005-1 offers fairly liberal transition relief for 2005 payout elections. If made in 2005, a payout election will not violate §409A, even if it does not conform with the new timing rules for changes in deferrals under §409A, even if it accelerates payout, and even if the plan's terms did not provide for this particular payout election before the end of 2005. The relief applies to all elections made in 2005--even elections governing amounts that will not become payable until after 2005. To qualify for the relief, the 2005 payout election must specify a payout time that conforms with §409A (e.g., payout on a fixed date or schedule, not before six months after separation for a key employee, etc.). Also, the plan document must be amended to provide for whatever election was actually made, no later than Dec. 31, 2005.

- *Deferral "cancellations" in 2005*. You may instead prefer that some participants' payout election be couched as the "cancellation" of their old deferral elections, rather than as a payout election. Canceling an old deferral election is in some respects identical to electing payout of a 2005 lump sum. The advantage of the "cancellation" characterization is that the payout does not have to conform with §409A. The disadvantage is that payouts pursuant to a cancellation must be distributed in 2005 (or the first taxable year of vesting, if later).

(d) *Elections subject to employer discretion*. Some plans allow participants to elect payouts subject to employer "discretion." Under §409A, these discretionary provisions are *no longer permitted*. After 2004, any payout elections of nongrandfathered amounts under these "employer discretion" clauses will be in violation of §409A. No transition relief is provided for elections of this type. Participants' payout election in 2005 must be squeezed to fit into the transition relief for 2005 elections outlined in (c) above. As with all 2005 elections made under this transition relief, the plan must be amended to provide for whatever elections are actually made, no later than Dec. 31, 2005.

(6) Determine Whether Any Plans Can Use the March 15 Election Transition Rule. The election transition rules described in 5(b) and (c) apply only to payout elections with respect to already deferred amounts. In addition, Notice 2005-1 provides a limited transition relief for initial deferral elections of amounts that have not yet been deferred.

The transition rule covers amounts that are attributable in whole or part to services performed before Dec. 31, 2005, if the amount was not paid or payable at the time of the election, under a plan in existence on ***Dec. 31, 2004***, if the election is made in accordance with the terms of the plan in effect on or before ***Dec. 31, 2005***. Thus, a plan in existence on Dec. 31, 2004, can be amended any time in 2005 to accommodate the transition relief. A plan is in existence on Dec. 31, 2004, for this purpose only if the written terms of the plan allowed deferral elections as of that date. Furthermore, only a "plan" of the same type counts--i.e., a defined benefit-type, defined contribution-type, or equity-based plan, covering the same individual. For compensation that meets all of these conditions, an election will be permitted, even if it does not meet the new election timing rule of §409A--that is, even if made after the start of related services--if the election is made by March 15, 2005.

What kinds of compensation are covered by this limited transition relief for elections? Only a few. Here are some examples:

(a) *Wraparound 401(k) plans*. Many 401(k) wraparound plans piggyback deferral elections off the participant's salary deferrals in the underlying 401(k) plan. These piggyback deferral elections typically violate §409A's timing rule for elective deferrals, because they are made during the year that services are rendered, rather than the year before. Wraparound 401(k) deferral elections are not eligible for the transition relief afforded in 2005 for wraparound plan payout elections. Thus, if you want to let participants make wraparound 401(k) deferral elections with respect to 2005 compensation, the March 15 rule is the only available relief. The March 15 rule is of course not useful for participant unwilling to make an irrevocable deferral election by that date.

(b) *Bonuses based on 2004 services*, but not yet earned and vested in 2004 because not determined by the compensation committee or employer until 2005.

(c) *2005 pay and bonuses for which a timely 2004 election was not supplied*. Examples include pay and bonuses first arising in 2005.

Notice 2005-1 is the first in an expected series of guidance issued by IRS. The full text of Notice 2005-1, as modified Jan. 5, 2005 (4 PBD, 1/6/05), appears in Internal Revenue Bulletin 2005-2 I.R.B. 274 (1/10/05).

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Back Search Contents