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Your Nonqualified Deferred Compensation Plans and the New Tax Law: What You Should Do Now — What Can Wait

The new tax law puts nearly every nonqualified deferred compensation plan into instant noncompliance on January 1, 2005. To avert sudden universal plan failure, Treasury staff has promised detailed guidance and a grace period in early 2005 for adopting plan amendments. But staff has also suggested that the grace period might only cover document failures, meaning that plans should be in operational compliance for nongrandfathered deferrals on January 1. Compensation directors are wondering what to do now and what can wait. Here is an action plan.

Before the end of 2004, make sure you:

- (1) Identify all plans and agreements with deferrals not vested as of December 31, 2004. These are not grandfathered and must comply with the new law.
- (2) Complete deferral elections for 2005 awards by December 31, 2004.
- (3) Amend, if you have time, by adding a generic provision stating that distributions or elections are not permitted if they trigger taxation under the new law. This puts your document in formal compliance, and gives you authority to ensure the plan's operational compliance in 2005. Adopting more specific amendments to enumerate permitted distributions and elections may be problematic.
- (4) Protect the grandfathered status of deferrals vested as of December 31, 2004. Make sure no direct or indirect amendment is a material modification that invalidates it.

In 2005, be prepared to operate the plan in immediate compliance with the new law. If Treasury has not released guidance, you may have to review, delay or even freeze questionable distributions and elections of nongrandfathered amounts. The generic amendment approach explained here will give you authority to do this while you wait for Treasury guidance.

What the New Law Provides

- Payments of deferred compensation must be scheduled to be made on a fixed date, fixed schedule, or permitted event (separation from service, death, *etc.*).
- No haircuts or other accelerations are allowed.
- Deferral elections must be made in the year before the service period begins (for performance-based pay, 6 months before the service period ends).
- Deferral elections made after these deadlines must be made at least 12 months *before* the originally specified initial payout occurs or is scheduled to occur, and must delay initial payout by at least 5 years *after* the originally specified payout time.
- Noncompliant deferrals are subject to immediate taxation, a 20% tax penalty, and interest from the date first earned or vested, if later.
- Grandfather for pre-2005 deferrals vested as of December 31, 2004, if the plan is not materially modified for old deferrals after October 3, 2004.
- Limited one-time window will allow an employee to rescind a pre-2005 deferral without penalty, and take the amounts into income when vested.

What To Do Now

1. Identify Plans with Nongrandfathered Deferrals

- Identify all plans and agreements with pre-2005 deferrals and awards not vested as of December 31, 2004. Elective and nonelective deferrals are affected, as are agreements with independent contractors. Don't overlook directors' pay plans, employment agreements, outside consulting agreements, severance pay plans, and deferred bonuses.
- To distinguish vested from nonvested deferrals, consider using the determinations you made under Code section 3121(v)(2) for FICA taxes. Or you can determine what amounts are not subject to a "substantial risk of forfeiture" under Code section 83.

2. Make Elections for 2005 Compensation in 2004

Treasury staffers have informally said any grace period will allow employers to cure defective documents, but not necessarily all defective elections.

- Ensure that deferral elections for 2005 compensation take place by December 31, 2004. For example, for bonuses earned during 2005 but paid in 2006, elections to defer payments to 2007 or later should be made by December 31, 2004. You can set a later election deadline for performance pay — but you risk later finding that the elections do not conform to Treasury's interpretation.
- Some companies have 2004 bonuses or long term performance awards payable in 2005, for which a deferral election is scheduled sometime in 2005. Accelerate the elections to 2004, just in case the bonus is vested as of December 31, 2004, and thus grandfathered, or in case Treasury grants transition relief.

- Warn participants that they may not be able to modify their elections without new restrictions.
- Deal with fiscal year plans. Some fiscal year plans are already incapable of offering good initial deferral elections. For example: let's say your plan awards bonuses on the basis of services performed between June 1, 2004, and May 30, 2005, with deferral elections allowed on December 31, 2004 — too late for an initial deferral election under the new law. If you think the award might qualify as performance based, schedule elections for November 30 (6 months before the performance period ends). If not, run the election anyway by December 31 and hope for transition relief.
- Some wraparound 401(k) plans piggyback deferral elections onto participants' qualified 401(k) plan elections. Consider decoupling these elections so that they don't rise and fall with qualified 401(k) plan elections, and accelerating the elections into 2004.
- Recognize that some types of plans will be difficult to fix by accelerating elections. For example, SERPs typically allow participants to elect between different forms or timing of payout at termination of employment. But under the new law, elections with respect to the payout of 2005 SERP accruals must be made in 2004. If made at a later time, they are subject to the 5-year rule and other restrictions on election changes. As a practical matter, 2004 elections for 2005 SERP accruals could be difficult or impossible to put in place. For most employers, the only practical solution may be to do nothing and hope that Treasury guidance cures problematic deferrals in SERPs and similar plans.

3. If You Have Time, Adopt a Generic Compliance Amendment

You may decide that it is impossible to amend and get any necessary approvals by year's end. In this case, you will have to rely on Treasury's promised amnesty for correcting document failures. But if you do not trust that there will be acceptable amnesty, consider adopting the following approach for minimum formal document compliance with the new law:

- a. Grandfathered Old Deferrals: Do Not Amend. Pre-2005 deferrals and awards vested as of December 31, 2004, are grandfathered. An amendment designed to tighten existing plan language is unnecessary. Any other kind of amendment risks being a "material modification" that blows up the grandfather. Bottom line: Don't touch these.
- b. All Other Amounts: Amend for Minimum Formal Compliance. Amend the plan so that the document is in formal compliance with the new law, as follows:
 - Keep your existing election and distribution provisions in the plan document. In this way, you don't have to spend time designing new ones that, in the absence of guidance, might later turn out not to conform to Treasury's interpretation.
 - But prohibit bad elections and distributions. Add an operational "override" provision stating that no otherwise permissible distribution or election is allowed that would trigger taxation of any amount under section 409A of the Code. The

point of this amendment is its very generality. It gives you authority to operate the plan in compliance by allowing you to stop, delay or review doubtful distributions and elections that the plan document would otherwise allow. You can even freeze distributions of nongrandfathered deferrals until Treasury has issued enough guidance to administer them.

- Permit good elections. Add a provision allowing deferral elections as permitted by the company or plan administrator. This will give you authority to hold initial deferral elections by December 31, 2004 for 2005 earnings, in a plan that otherwise might not allow it. This approach doesn't require you to give the election — it merely gives you the authority.

An alternative amendment approach is to specify permitted distribution options and elections. This approach may be problematic. If drafted before guidance is issued, enumerated distribution options may conflict with later guidance, or will have to be drafted so generally that it is unhelpful for plan administration. Changing distribution options for nonvested pre-2005 deferrals risks invalidating the grandfather, while changing distribution options only for 2005 and later deferrals risks creating multiple “buckets” of deferrals requiring separate administration. Amendments made this year will likely require re-amending next year, when guidance fills in the gaps in the new law.

4. Protect Your Grandfathered Deferrals

- Begin setting up an accounting system to keep active plans with grandfathered pre-2005 deferrals and awards separate from other amounts (or you might prefer to give up the grandfather protection, if permitted by the plan).
- Keep a close eye on plan amendments and other disguised benefit enhancements that might blow up the grandfather protection. Watch for surprises. For example, benefit enhancements to your qualified plan might be a material modification to your nonqualified excess plan if the qualified plan amendment increases spillover benefits or adds new distribution options to the excess plan.

What To Do In 2005

In 2005, be prepared to operate the plan in immediate compliance with the new law. If Treasury has not released guidance, you may have to review, delay or even freeze questionable distributions and elections of nongrandfathered amounts. The generic amendment approach explained here will give you authority to do this while you wait for Treasury guidance. The practical effect on plan participants will be minor, as most distributions in early 2005 will probably be of grandfathered deferrals. When guidance is issued, you can conform your plan administration and your plan documents to the new guidance.