



NYLEX News

Premier Executive Benefits Plan Services

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To our clients and friends

This issue of NYLEX News discusses Notice 2005-1, recently issued by Treasury and the Internal Revenue Service. Notice 2005-1 provides guidance under Section 409A of the Internal Revenue Code, enacted by the American Jobs Creation Act of 2004 in October 2004. This legislation affects the design and operation of nonqualified deferred compensation arrangements, including supplemental executive retirement plans (SERPs) and stock-based compensation plans. Please send comments about this article, as well as suggestions for future issues, to our Stamford, CT office.

NOTICE 2005-1

- Deferred compensation plans are still valuable, although abuses have been curbed
- Liberal transition provisions give taxpayers until 12-31-2005 to amend plans
- Following the rules is more important than ever

INTRODUCTION

In December, 2004, Treasury and the Internal Revenue Service (IRS) issued Notice 2005-1, which is the first in an expected series of releases providing guidance under Section 409A, Internal Revenue Code, as enacted by the American Jobs Creation Act of 2004 (the Act). This Section sets forth new federal income tax rules for deferred compensation arrangements.

Section 409A provides that all amounts deferred under a nonqualified deferred compensation arrangement in years after 2004 are currently taxable when vested (i.e., not subject to a substantial risk of forfeiture), unless certain requirements are met. Although the Act affirms that deferred compensation plans do work, the rules that previously governed these plans have changed, in some cases significantly. Importantly, however, these plans still provide sponsoring employers and participants valuable tax savings opportunities. Also, the Act does not restrict the valuable financing alternatives that have been used to fund these plans.

This newsletter includes a brief summary of the guidance contained in Notice 2005-1. Treasury and the IRS plan to issue additional guidance, which

should explain further how the Act will affect deferred compensation arrangements.

The bottom line – Although the new rules are effective for amounts deferred after December 31, 2004, the Notice includes liberal transition rules that make clear that a plan will not be considered to have violated the rules regarding elections, timing of distributions and acceleration of benefits if the plan makes a good faith effort to comply with the new rules and the plan is amended by December 31, 2005 to conform to the new law.

NOTICE 2005-1

Notice 2005-1 is organized as a series of questions and answers and covers:

- Arrangements that will be considered deferred compensation plans
- Acceleration of deferred compensation distributions
- Definition of change in control
- Transitional rules and effective dates
- Reporting and withholding issues

DEFERRED COMPENSATION PLANS DEFINED

The Notice defines a deferred compensation plan as any agreement, method or arrangement that provides for a deferral of compensation, even if it

applies only to one person or individual. A deferral of compensation occurs if the service provider (employee) has a legally binding right to compensation that has not been actually or constructively received and that, in accordance with the plan, is payable in a later year.

There is no legally binding right to compensation if the service recipient (employer) has the unilateral right to reduce or eliminate the amount of the compensation after the services have been performed. However, if the facts and circumstances indicate that this right is exercisable only upon a condition that is unlikely to occur, or the discretion to reduce or eliminate the compensation is unlikely to be exercised, the employee will be considered to have a legally binding right to the compensation.

Short term deferrals may not be considered to constitute deferred compensation arrangements. For example, compensation paid after the end of the employee's taxable year pursuant to the usual timing arrangement for paying employees on a payroll period basis is not considered a deferral. Also, until additional guidance is issued, payment within 2½ months after the end of either the employee's or employer's first taxable year after compensation vests will not constitute a deferral.

Equity based plans – Grants of Incentive Stock Options (ISOs) or options under a qualified employee stock purchase plan do not constitute a deferral of compensation. Also, the grant of a nonstatutory stock option will not be considered deferred compensation if: (1) the option exercise price is at least fair market value on the date of grant; (2) receipt of the option is taxable under Section 83 of the Code; and (3) the option does not include any feature for deferral of compensation other than the deferral of recognition of income until the exercise or disposition of the option.

Stock Appreciation Rights (SARs) will be treated as resulting in a deferral of compensation unless: (1) the SAR exercise price is at least equal to fair market value on date of grant; (2) the stock of the employer subject to the right is traded on an established securities market; (3) only such traded stock may be delivered in settlement of the right; and (4) the right does not include any feature for deferral of compensation other than the deferral of recognition of income until the exercise of the right. A transitional rule applicable to SARs states that, until further guidance is issued, if a right is granted pursuant to a plan that was in existence on October 3, 2004, payment of cash or stock on exercise, or cancellation of the right for consideration will not be treated as payment of deferred compensation if: (1) the SAR exercise price is at least fair market value on date of grant; and (2) the right does not include any feature for deferral of compensation other than the deferral of recognition of income until the exercise of the right.

Parties to the arrangement – The service recipient is defined as the person for whom the services are performed and all related persons under Sections 414(b) and 414(c). The service provider is the person performing the services.

A deferred compensation plan is not limited to arrangements between employers and employees. Section 409A may apply to an arrangement involving an independent contractor, or under certain circumstances, an arrangement between a partner and a partnership.

Section 409A does not apply to an arrangement between parties, all of whom use the accrual method of accounting. Also, Section 409A does not apply to a service provider who is actively engaged in the business of providing substantial services other than as an employee or as a director of a corporation, and who provides such servic-

es to two or more recipients who are not related to each other or to the service provider. Treasury and the IRS intend to issue additional guidance concerning service providers who are not subject to Section 409A.

Section 457(f) plans – Section 409A applies to “ineligible” nonqualified deferred compensation plans of tax exempt institutions in addition to the Section 457(f) rules that already are applicable. However, certain definitions, including that of deferred compensation, are different in the two Sections, and different rules apply to determine amounts that are considered vested. Section 409A does not apply to “eligible” Section 457(b) plans.

ACCELERATION OF DISTRIBUTIONS

A plan may not permit the acceleration of time or schedule of any payment under the plan, except in the following circumstances:

- To comply with a domestic relations order
- To comply with a conflict of interest divestiture requirement
- In order to distribute funds to an ineligible Section 457(f) plan participant to pay income taxes due because of a vesting event, as long as the payment does not exceed the amount of income tax withholding that the employer would have remitted if wages had been paid equal to the income includible by the participant
- To permit a payment upon termination of the participant's interest in the plan upon separation from service, if the payment is not deferred and does not exceed \$10,000
- To pay the FICA tax due on compensation deferred under the plan and the income tax withholding on such FICA amount

CHANGE IN CONTROL

Pursuant to Section 409A, a plan may permit a payment upon a change in ownership or change in effective control of the corporation. Notice 2005-1 provides that to qualify as a Change in Control Event, the event must be objectively determinable and not subject to discretionary authority by any person or group, such as the board of directors, to decide whether the event has occurred. The plan, however, may provide that the corporation has the discretion to decide whether or not to make a payment if, in fact, a Change in Control Event has occurred.

To constitute a Change in Control Event as to a participant, the Event must relate to (1) the corporation for whom the participant is performing services at the time of the Event, (2) the corporation(s) liable for payment of the deferred compensation, or (3) a corporation that is a majority shareholder of the corporation in (1) or (2) above or is further up that ownership chain.

For these purposes, change in ownership means the first time a person or group of persons has ownership of more than 50% of the total fair market value or total voting power of the corporation.

Change in the effective control of a corporation occurs (1) when a person or group acquires during a 12 month period ownership of stock having 35% or more of the total voting power of the corporation, or (2) a majority of the board of directors is replaced during a 12 month period by directors whose election or appointment is not endorsed by a majority of the previous board.

Also qualifying as a Change in Control Event is a change in the ownership of a substantial portion of a corporation's assets, which occurs when within a 12 month period a person or group acquires assets comprising 40% or more of the total fair market value of the corporation's assets.

TRANSITIONAL RULES AND EFFECTIVE DATES

Section 409A is effective with respect to amounts deferred after December 31, 2004 and amounts deferred before that date pursuant to plans that are materially modified after October 3, 2004.

Notice 2005-1 states that an amount will be considered deferred before January 1, 2005 only if the employee has a legally binding right to be paid and the amount is earned and vested on that date.

Vesting – An amount is considered as not vested, that is, subject to a substantial risk of forfeiture, if the right to the amount is subject to the performance of substantial future service or the occurrence of a condition related to the service and the possibility of the forfeiture is substantial. Any extension of the forfeiture period or any addition of a substantial risk of forfeiture after the measurement period of the service has commenced is disregarded. Also, for purposes of Section 409A, a covenant not to compete will not be considered as involving a substantial risk of forfeiture.

The Notice provides that for a risk of forfeiture to be effective, the amount the employee anticipates receiving must be materially greater than the amount he or she otherwise could have received. Therefore, salary deferrals generally may not be made subject to a substantial risk of forfeiture. However, an election to receive a materially greater bonus in a later year rather than a materially lesser bonus in an earlier year may be made subject to a substantial risk of forfeiture.

In determining whether the possibility of forfeiture is substantial, the determination as to whether the employer will enforce the condition must take into account the position of the service provider in the corporation and the extent of his or her ownership interest.

Grandfathered amounts – Notice 2005-1 provides guidelines for determining the amount of compensation deferred

prior to January 1, 2005, and thus subject to the grandfathering rules of Section 409A, depending on the nature of the deferral plan:

- **Account balance plans** – the amount of compensation deferred equals the portion of the participant's account that is earned and vested on December 31, 2004
- **Nonaccount balance plans** – The amount deferred at December 31, 2004 equals the present value on that date of the amount the participant would be entitled to if he or she voluntarily terminated services without cause on that date and received full payment from the plan on the earliest possible date following termination, to the extent that amounts were earned and vested on December 31, 2004
- **Equity based plans** – the rules applicable to account balance plans are applied, with the account balance deemed to be the payment that would be due the participant on December 31, 2004, the right to which was earned and vested, less any exercise price or amount payable by the participant

Earnings on amounts deferred before January 1, 2005 also are grandfathered, including notional earnings credited to the participant's account.

Grandfathering will be forfeited, and amounts will be subject to the rules of Section 409A, if a plan is materially modified after October 3, 2004. Therefore, it will be important for many plans and participants to avoid any plan changes that could be deemed material modifications.

Notice 2005-1 provides that a plan will be considered as materially modified if a pre-existing right is enhanced or a new benefit or right is added. Such a material modification will be deemed to have occurred whether it occurs pursuant to a change in the terms of the plan or through the employer's exercise of dis-

cretion under existing plan provisions.

It is not a material modification for an employer to exercise discretion as to the time or manner of payment of a benefit if such discretion was provided by the plan on October 3, 2004, or to change a notional investment measure. Also, a plan participant may exercise a right permitted under the plan as it was in effect on October 3, 2004.

The addition of a right or benefit will be considered a material modification even if that is a right or benefit permitted under Section 409A. However, the reduction of an existing benefit would not be a material modification.

Many employers are weighing whether or not to “freeze” existing plans and establish new plans to accept deferrals after December 31, 2004. The Notice states that amending an arrangement to stop future deferrals is not a material modification. Also, amending an arrangement on or before December 31, 2005 to terminate the arrangement and distribute amounts deferred will not be considered a material modification, as long as all amounts deferred are included in income in the year in which the termination occurs. Of course, replacing an existing plan with a similar one for future deferrals must be done carefully and in consultation with the employer’s professional advisors.

Other transitional rules – Recognizing the fact that Notice 2005-1 was issued on December 20, 2004 and Section 409A is effective for amounts deferred on or after January 1, 2005, Treasury and the IRS provided in the Notice that plans adopted before December 31, 2005 will not be treated as violating the rules regarding elections, timing of distributions and acceleration of benefits if (1) the plan is operated in good faith compliance with the provisions of §409A

and Notice 2005-1 during calendar year 2005, and (2) the plan is amended on or before December 31, 2005 to conform to the provisions of §409A with respect to amounts subject to §409A. To the extent an issue is not addressed in Notice 2005-1, a good faith, reasonable interpretation of Section 409A is required.

For plans in existence on December 31, 2004, the more restrictive Section 409A rules with regard to deferral elections will not apply as long as (1) a deferral election is made by March 15, 2005, (2) the election is applicable to amounts not yet paid or payable, (3) the election is made in accordance with the terms of the plan as it then existed, (4) the plan otherwise is operated in accordance with Section 409A with respect to post 2004 deferrals and (5) by December 31, 2005 the plan is amended to comply with Section 409A.

In the case of bonus (performance based) compensation, Notice 2005-1 provides that a deferral election for bonus compensation based on services to be performed over a period of at least 12 months will be considered as meeting the requirements of Section 409A if it is made at least six months before the end of the performance period. For this purpose, bonus compensation refers to compensation where the payment or amount is contingent on company or individual performance criteria and the performance criteria are not substantially certain to be met when the deferral election is permitted. Subjective performance criteria are allowed, but such criteria must relate to the performance of the employee or a group including him or her, and the evaluation of performance must not be made by the employee or family member. Bonus performance criteria cannot be based

solely on the value or appreciation in value of the employer or the employer’s stock.

The Notice cautions that future guidance to be issued regarding performance based compensation is expected to be more restrictive than the interim guidance discussed in the preceding paragraph.

REPORTING AND WITHHOLDING ISSUES

Section 409A requires that amounts deferred under a nonqualified deferred compensation plan be reported on Form 1099 or Form W-2, as appropriate. Those amounts are reportable whether or not they are includible in gross income. Amounts subject to these information reporting requirements include amounts deferred under a nonaccount balance plan, unless the amounts are not reasonably ascertainable. Treasury and the IRS plan on issuing guidance that provides a method for calculating the amount of deferrals for the year.

Treasury has the authority to establish a minimum amount below which the reporting requirements do not apply. Until further guidance is issued, employers may exclude annual deferrals that for an individual employee do not in the aggregate exceed \$600.

The information reporting requirements are effective for amounts actually deferred in calendar years beginning after December 31, 2004. For these reporting purposes, amounts are considered deferred when the employee has a legally binding right to the compensation. Thus, the information reporting requirements are not effective for amounts actually deferred in calendar years before 2005 or income attributable to such amounts, even though Section 409A may treat those amounts as having been deferred in subsequent years for

purposes of the effective date provisions.

For withholding tax purposes, “wages paid” include amounts includible in gross income of an employee under Section 409A. For calendar year 2005, amounts includible in gross income under Section 409A but neither actually or constructively received may be treated as having been paid for withholding tax purposes on any date on or before December 31, 2005, although an earlier date than December 31 may be required by some other provision of the law.

If the employer is required to furnish the employee an expedited Form W-2 before January 31, 2006 for income earned in 2005, and if additional guidance has not been issued by Treasury and the IRS providing methods for determining the amount of deferrals for the year or amounts includible in gross income under Section 409A, the employer needs to include those amounts on the W-2. However, when the guidance is issued, the employer will be required to furnish a corrected W-2 to the employee.

CONCLUSION

Although Notice 2005-1 provides welcome guidance for employees and employers seeking to navigate the new Section 409A rules, many issues still are unresolved. Still to be addressed are:

- How Section 409A will be applied to nonelective plans, such as SERPs and bonus arrangements
- How severance plans will be treated under Section 409A
- Further guidance with respect to performance based compensation

- Elections to change the form and timing of distributions
- The use of domestic and foreign rabbi trusts

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- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration

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- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

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