

Non-Qualified Deferred Compensation Guidance: IRS Proposed Regulations Provide Some Relief Until 2007

Last week the IRS issued Proposed Regulations (the "Regulations") providing extensive additional guidance regarding the non-qualified deferred compensation provisions contained in section 409A ("409A") of the Internal Revenue Code ("Code"). The Regulations provide critical additional transition relief from some, but not all, of the provisions of the new law, which was otherwise scheduled to go into effect fully on January 1, 2006.

Extension of Application of Prior Guidance

The IRS previously issued Notice 2005-1 ("Notice"), which provided preliminary guidance and transition relief for 2005, since 409A was effective January 1, 2005. Because the Regulations will not be finalized and effective until January 1, 2007, the IRS has extended through 2006 much of the transition relief provided by the Notice. However, some of the transition relief in the Notice is not being extended beyond 2005, so there still may be actions appropriate for certain employers that must be taken by December 31, 2005.

Amendment Relief from the New Rules

Amendments to non-qualified deferred compensation plans and agreements to comply with 409A are not required to be made before December 31, 2006. Care must be taken in making decisions on operational issues prior to actual amendment, however, since some of the operational decisions will limit or affect those amendments.

Operational Good Faith Compliance Requirements

While amendments are not required, you must *operate* non-qualified deferred compensation plans and agreements in good faith compliance with 409A and the Notice throughout the remainder of 2005 and 2006. Plans may, if they wish, follow the rules of the Regulations, even if they are inconsistent with the provisions of the Notice, and that also will be considered good faith compliance.

Other Transition Relief

The transitional relief provided by the Regulations includes the following:

A. Changes in Payment Elections

The Notice provided that with respect to amounts previously deferred and subject to 409A, a plan could be amended to provide for new payment elections without violating the subsequent deferral and anti-acceleration rules, so long as the plan was amended and the participant made the election by December 31, 2005. The Regulations extend this right through December 31, 2006, but the amendment and payment elections cannot apply to amounts that would otherwise be payable in 2006 and cannot cause amounts to be paid in 2006 that otherwise would not be payable in that year.



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B. Linked Plans

The Notice set forth a special rule for non-qualified deferred compensation plans that link the time and/or form of benefit payments to elections made under a Code section 401(a) qualified plan. These "linked plans" were permitted to continue operating on a linked basis through December 31, 2005, with respect to amounts deferred before and after December 31, 2004, so long as the determination of the time and form of payment is made under the terms of the non-qualified deferred compensation plan as of October 3, 2004. This transition relief is extended until December 31, 2006, but the Regulations do not permit the linking of payments under the plans on a permanent basis.

C. Previously Adopted Unwritten Arrangements

The Regulations for the first time impose a new requirement that all non-qualified deferred compensation plans be set forth in writing. Employers may establish plans at any time prior to December 31, 2006 without reducing them to writing at the time they are established, so long as they are reduced to writing by December 31, 2006.

D. Designations of Key Employees of Public Companies

The Regulations provide rules for specifying an identification date for determining key employees and setting forth that date in the plan documents or a separate document. However, the Regulations provide that any designation of an identification date made on or before December 31, 2006, may be applied to any separation from service occurring on or after January 1, 2005.

Transition Relief Not Extended

A. Initial Deferral Elections For 2005


The Notice permitted certain initial deferral elections for 2005 to be made or changed by March 15, 2005. No similar relief is provided for 2006, so deferral elections for amounts earned in 2006 generally must be made by December 31, 2005.

B. Deferral Cancellations and Plan Participation Termination

The Notice permitted a plan adopted before December 31, 2005 to be amended before December 31, 2005, to provide a participant with the right to terminate participation in the plan or cancel an outstanding deferral election subject to 409A, so long as the amount subject to the termination or cancellation is includible in income in 2005 or, if later, when earned and vested. This relief is not extended beyond 2005. However, the Regulations treat the exercise by December 31, 2005, of a stock option, stock appreciation right or other similar equity appreciation right that provides for a deferral of compensation (for example, a stock option with an exercise price less than 100% of fair market value at the date of grant) as a cancellation of a deferral, so that exercise during 2005 will avoid application of 409A.

C. Termination of Grandfathered Plans

The Notice permitted an arrangement that was grandfathered from the requirements of 409A (i.e., a plan in existence on October 3, 2004) to be amended, on or before December 31, 2005, to terminate the arrangement and distribute the amounts of deferred compensation in the year of plan termination without that amendment being treated as a "material



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modification" that otherwise would bring the grandfathered plan under the requirements of 409A. This relief is not extended beyond 2005.

D. Funded Plans

The Notice did not, and the Regulations do not provide guidance or transition relief with respect to offshore funded plans or plans funded based upon an employer's financial health. Therefore, unless addressed in the future, these provisions were effective January 1, 2005.

Scheduled Teleconference

While the Regulations provide additional time for employers to address a number of the issues affecting their non-qualified deferred compensation plans affected by 409A, a number of the new rules will apply in 2005 to certain elections related to 2006 income. We are offering employers additional information regarding these new Regulations in two teleconference briefings on the Regulations on October 10 and 20, 2005. Please go to our website, www.haynesboone.com (select upcoming seminars) to register for the teleconferences. You must register for each of the teleconferences separately. However, the second session will build on the basic features of the guidance and 409A rules discussed in the first session and will further explore the transition relief, the application to inbound and outbound employees, and other practical issues.

If you have any questions regarding the foregoing, or for assistance in complying with 409A and the Regulations, please feel free to contact one of the attorneys listed below.

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