

UPDATE ON NONQUALIFIED DEFERRED COMPENSATION

In late 2004 we provided you information about a new law affecting nonqualified deferred compensation. This updates that information with a summary of the new law and a list of actions needed during 2005 and 2006.

The new law (Section 409A) applies to nonqualified deferred compensation

The new law is Section 409A of the Internal Revenue Code. Section 409A applies to nonqualified deferred compensation. Generally, *nonqualified deferred compensation* is compensation payable under any arrangement that defers the receipt of the compensation to a later year, for an employee or an independent contractor. For example, severance pay to be paid in a later year could be nonqualified deferred compensation. *Nonqualified deferred compensation* excludes, however, compensation payable under:

- Qualified retirement plans
- Bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans
- Medical savings accounts, health savings accounts, medical reimbursement plans, and health reimbursement arrangements that satisfy tax-qualification requirements
- Arrangements under which compensation is paid by the 15th day of the 3d month after the end of the later of the employee's (or the independent contractor's) or employer's taxable year in which the compensation vests, if the arrangement does not provide for payment after this 15th day

Grandfathered nonqualified deferred compensation

Section 409A does not apply to nonqualified deferred compensation that was earned and vested on December 31, 2004 ("grandfathered nonqualified deferred compensation"), unless the arrangement under which the compensation is deferred is

materially modified after October 3, 2004. Section 409A applies to all other nonqualified deferred compensation.

Why you care about Section 409A

Not complying with Section 409A would result in the following:

- Immediate tax. The employee or independent contractor would be taxed immediately on all vested nonqualified deferred compensation that has not previously been taxed.
- Additional 20% tax and interest. The employee or independent contractor would owe, in addition to the regular tax, an additional 20% tax on the taxed nonqualified deferred compensation, and also interest on the deferred tax for the period that taxation of the compensation has been deferred.

What Section 409A requires

Section 409A restricts nonqualified deferred compensation in the following ways:

- When elections to defer may be made. Employees and independent contractors may elect to defer compensation only before their taxable year in which they earn the compensation. There are limited exceptions, such as for certain performance-based compensation.
- When nonqualified deferred compensation may be paid. Nonqualified deferred compensation may be paid only at certain times or upon certain events.
- When the time and form of payment must be specified and may be changed. The time at which nonqualified deferred compensation is to be paid (e.g., at termination of employment or age 65), and the form in which it is to be paid (e.g., lump sum or installments), generally must be specified before their taxable year in which the employee or independent contractor earns the compensation. Permitted changes to the time and form of

payment are limited, and generally may not accelerate payment.

- Assets must be in the United States; no financial health trigger. Assets set aside to pay nonqualified deferred compensation must be located in the U.S. and may not be restricted to paying nonqualified deferred compensation if the employer's financial health changes.

Section 409A also adds requirements for information reporting of nonqualified deferred compensation, for withholding income tax on employees' nonqualified deferred compensation that violates Section 409A, and for information reporting of independent contractors' nonqualified deferred compensation that violates Section 409A.

Actions needed by December 31, 2005

The following actions are needed by December 31, 2005:

- Participant elections to defer 2006 compensation. Elections by employees and independent contractors to defer 2006 compensation must be made by December 31, 2005. There are limited exceptions, such as for certain performance-based compensation and for employees and independent contractors whose taxable year is not the calendar year.
- Participant cancellations of their elections to defer 2005 compensation, or of participation, and authorizing amendments. Employees and independent contractors who want to cancel their elections to defer 2005 compensation or their participation in a nonqualified deferred compensation arrangement must elect the cancellation by December 31, 2005. Amendments authorizing these cancellations must be adopted by December 31, 2005.
- Amendments to terminate grandfathered nonqualified deferred compensation arrangements, and distributions under the amendments. If a grandfathered nonqualified deferred compensation arrangement is to be terminated early, an amendment terminating the arrangement must be adopted by December 31, 2005. Also, distributions under the amendment must be made by December 31, 2005.
- Participant elections of a new payment schedule, and authorizing amendments. Employees and

independent contractors who want to elect a new payment schedule for nonqualified deferred compensation must make this election by December 31, 2005. Amendments authorizing these elections must be adopted by December 31, 2005. These elections and amendments may be made in 2006, but if made in 2006 may not affect payments scheduled for 2006 and may not cause additional payments to be made in 2006.

- Amendments authorizing late deferral elections made during January 1-March 15, 2005, for 2005 compensation. If employees or independent contractors made deferral elections during January 1-March 15, 2005, for 2005 compensation, amendments authorizing these late elections must be adopted by December 31, 2005.

Action needed by December 31, 2006

By December 31, 2006, all nonqualified deferred compensation arrangements to which Section 409A applies must be amended to comply with Section 409A. The Internal Revenue Service recently extended this deadline from December 31, 2005.

Action needed after October 3, 2004, for grandfathered nonqualified deferred compensation

Arrangements to pay grandfathered nonqualified deferred compensation should not be materially modified after October 3, 2004.

Action needed after December 31, 2004, for all other nonqualified deferred compensation

All other arrangements to pay nonqualified deferred compensation must be administered in compliance with Section 409A.

Getting help

This Update gives you a general description of Section 409A. This Update is not legal advice. For help with nonqualified deferred compensation, please contact one of the following attorneys in our Employee Benefits Group:

Craig Smith
Everett Moreland
Vicki Rees