ROBINSON & COLE LLP

Employee Benefits & Compensation

IRS Releases Guidance on Non-Qualified Deferred Compensation

As previously reported in a Special Edition of Benefits e-News, the American Jobs Creation Act signed into law earlier this year added Section 409A to the Internal Revenue Code. If the requirements of Section 409A are not satisfied, all amounts deferred under a non-qualified deferred compensation plan will be taxable to an individual to the extent that such amounts are not subject to a substantial risk of forfeiture and were not previously included in gross income. This week the IRS issued Notice 2005-1which provides limited initial guidance on the application of new Section 409A. The IRS has indicated that additional guidance will be issued during 2005.

Unfortunately, the Notice does not provide detailed guidance on many issues. In cases where the Notice does not provide specific guidance, employers will be protected if they operate their plans using a good faith, reasonable interpretation of Section 409A.

Transition Relief

Section 409A becomes effective January 1, 2005. Because of the short period of time between the passage of AJCA and that effective date, many employers have been concerned with the need to amend plan documents to comply with the new rules by January 1, 2005. The Notice states that employers have until December 31, 2005 to amend their non-qualified plans to comply with Section 409A. However, until such amendments are adopted, the plan must be operated in good faith compliance with Section 409A and Notice 2005-1, regardless of the current terms of the plan.

If an employer does not want to adopt the new rules for plans in existence on October 3, 2004, it can freeze benefits under that plan as of December 31, 2004. Benefits under such a frozen plan will be unaffected by the new law as long as the existing plan is not materially modified. Alternatively, if an employer determines that it does not want to continue offering non-qualified deferred compensation in light of the new rules, it can terminate a plan that was in existence on October 3, 2004. Although Section 409A generally prohibits employers from making distributions upon plan termination, under a transition rule, distributions can be made from a plan that is terminated before December 31, 2005.

A plan can be amended before December 31, 2005 to allow participants to terminate participation in the plan or cancel deferral elections during 2005 with respect to amounts deferred during 2005 or termination. In such a case, the amounts subject to cancellation will be included in the participant’s income when earned and vested.

Employers have also been concerned with the proper manner in which employees should

make deferral elections for 2005. The Notice provides that any deferral election made on or before March 15, 2005 will be valid if it relates to services performed before December 31, 2005, provided that the amounts to which the election relates have not yet been paid at the time of the election, the election is made in accordance with the terms of the plan, the plan is operated in accordance with Section 409A and the plan is timely amended to comply with the new rules. Although Section 409A generally requires an election to defer a bonus to be made at least six months before the bonus is paid, in the case of a bonus that is to be paid on or before March 15, 2005, the election can be made at any time before the bonus is actually paid.

Many excess benefit plans and SERPs provide that distribution to a participant will be made in the same manner in which the participant elects to receive the corresponding qualified plan benefit. If a plan provided for such coordinated distribution forms on October 3, 2004, the plan can continue to be administered according to this rule throughout 2005. After 2005, non-qualified deferred compensation must be paid in accordance with the new rules under Section 409A.

Guidance

Identifying Covered Arrangements. Although qualified employee stock purchase plans under Section 423 are not subject to the new rules, the guidance clarifies that this exception does not extend to non-qualified stock purchase plans. The Notice also clarifies that arrangements between a partner and a partnership can constitute a deferred compensation arrangement subject to Section 409A.

A deferred compensation arrangement does not arise solely because compensation is paid after the last day of the employee's taxable year pursuant to a timing arrangement under which the employer normally compensates employees. A deferred compensation arrangement will not result if an employee does not make an election to defer and the terms of a plan require payment within two and a half months from the end of the employee's taxable year in which the amount is no longer subject to a substantial risk of forfeiture or, if later, two and a half months from the end of the employer's taxable year in which the amount is no longer subject to a substantial risk of forfeiture. These provisions will allow most pure bonus arrangements that do not allow additional deferrals to avoid Section 409A. The Notice states that bonus programs that span a period of years and provide for payment to the employee within a short period following the end of the bonus program are also not subject to Section 409A.

Change in Control. A non-qualified deferred compensation plan can allow distribution of deferred amounts in the case of a change in control event. The Notice defines 'change in control event' to include: a change in the ownership of a corporation, a change in the effective control of a corporation, or a change in the ownership of a substantial portion of the assets of the corporation. Distribution can also be made in the event that a plan is terminated after a change in control and the decision of whether or not to terminate the plan can be discretionary. The determination as to whether or not a change in control event

has occurred must be objectively determined and cannot involve a discretionary determination by an administrator, unlike the termination of the plan.

Acceleration of Distributions. The Notice clarifies that Section 409A prohibits plans from allowing an acceleration of distributions, although an acceleration of vesting that does not trigger a distribution is permissible. The Notice provides the following exceptions to this rule: distributions required to fulfill a domestic relations order; distributions required to comply with a certificate of divesture; and distributions required to pay FICA tax on compensation deferred under the plan. In the case of a Section 457(f) plan, payments can be accelerated to pay income taxes due upon a vesting event. Also, a plan can allow acceleration of distributions not greater than $10,000 in certain cases.

Stock Appreciation Rights. The Notice provides guidance with respect to how stock appreciation rights that are subject to Section 409A can be designed to comply with the new rules. The Notice exempts from the requirements of Section 409A stock appreciation rights that do not present the potential for abuse or are not intended to circumvent Section 409A. Generally, to qualify for transitional relief the SAR must be granted at least at fair market value. Publicly traded corporations have additional relief.

Effective Date

Section 409A becomes effective with respect to amounts deferred on or after January 1, 2005. On and after January 1, 2005, in cases where the Notice does not provide specific guidance, the guidance indicates that employers will be protected if they operate their plans using a good faith, reasonable interpretation of Section 409A.

Veterans Benefits Improvement Act Expands USERRA Obligations

The recently enacted Veterans Benefits Improvement Act of 2004 requires employers to provide affected employees with an annual notice of their rights and obligations under USERRA. The notice requirement can be satisfied through posting at a location in the workplace, such as on an employee bulletin board. The DOL will be issuing a form notice that can be used for this purpose.

Employers are currently required to offer health care continuation coverage for up to 18 months to employees who are serving in the military. The Act increases this period to 24 months for employees electing coverage on or after December 10, 2004.

IRS Issues Regulations Intended to Curb Abusive ESOP Practices

The IRS has issued regulations relating to prohibited allocations under an ESOP that holds stock of a Subchapter S Corporation. An ESOP is permitted to hold stock of an S Corporation only if it benefits a broad based group of employees. Under Section 409(p) of the Internal Revenue Code, an ESOP holding stock in an S Corporation must require that no portion of the plan assets attributable to employer securities can, during a non-allocation year, be allocated for the benefit of a disqualified person. A non-allocation year occurs

during any year that the ownership interest in the S Corporation is so concentrated among disqualified persons that such persons hold 50% or more of the interest of the Corporation.

In determining whether or not a person is a disqualified person, the regulations look at the synthetic equity of the person in question. Use of the synthetic equity approach prevents dilution of a person's ownership involving stock options or stock appreciation rights. The regulations expand the concept of synthetic equity to include the right to acquire stock or assets and exclude non-qualified deferred compensation that has been taken into account for social security tax purposes and that was outstanding before the date on which the ESOP acquired employer securities. The regulations include a person by person approach to applying the synthetic equity rules.

The IRS has posted a letter on its website informing S Corporations that sponsor ESOPs of the new regulations and alerting them to the fact that it is examining such ESOPs for potential abusive practices.

DOL Clarifies Scope of a Directed Trustee's Fiduciary Responsibilities

The DOL has issued Field Assistance Bulletin 2004-03 addressing the fiduciary responsibilities of a directed trustee with respect to purchase and holding of publicly traded employer securities. Under ERISA, the fiduciary duties of a directed trustee subject to the direction of a named fiduciary are narrower than the duties of a discretionary trustee. A directed trustee can only accept proper directions from a fiduciary when those directions are made in accordance with the terms of the applicable plan and are not contrary to ERISA. The directed trustee may not follow directions that it knows or should know are not in compliance with the terms of the plan or are contrary to ERISA.

A directed trustee may be liable for a breach of fiduciary duty to follow proper directions if it follows an improper direction, such as a direction that is contrary to the terms of the plan. The Field Assistance Bulletin states that directed trustees have a duty to review all documents governing the plan that are relevant to its duties. If a directed trustee fails to review relevant documents and follows directions that are contrary to the terms of the plan, it may be liable on the basis that it should have known that the direction was not in accordance with the plan. The Field Assistance Bulletin states that if a directed trustee finds the plan documents to be ambiguous, it should obtain a clarification of the interpretation of the plan terms from the fiduciary responsible for interpreting the plan in order for the directed trustee to make a determination as to whether or not a particular direction is proper.

A directed trustee cannot follow any direction that is contrary to ERISA. Accordingly, the Field Assistance Bulletin requires directed trustees to follow processes designed to avoid prohibited transactions. To satisfy this obligation, a directed trustee can obtain written representations from the directing fiduciary that the plan maintains and follows procedures identifying prohibited transactions, and that directed trustee can rely on those representations unless the directed trustee knows that the representations are false.

The Field Assistance Bulletin reiterates the DOL's position that a directed trustee's

responsibility for determining the prudence of a particular transaction is limited, and that the directed trustee does not have an independent obligation to determine the prudence of each transaction in which it is involved. However, a directed trustee has an obligation to inquire as to the prudence of a transaction when the directed trustee possesses material non-public information regarding a security. In such a case, the directed trustee has a duty to inquire about the named fiduciary's knowledge and consideration of that information with respect to the direction. The Field Assistance Bulletin provides an example in which the directed trustee cannot follow a direction to purchase a particular company's stock if the directed trustee has non-public information indicating that the company's financial statements contain material misrepresentations that significantly inflate its earnings. The Field Assistance Bulletin states that in limited, extraordinary circumstances, where there are clear and compelling indicators that call into serious question a company's viability as a going concern (such as an 8-K filing with the SEC or bankruptcy filing), the directed trustee may have a duty to refuse follow the named fiduciary's instructions without further inquiry. However, the Field Assistance Bulletin reiterates that a directed trustee can follow a named fiduciary's direction absent extraordinary circumstances.

This is an archive of past issues. As a result, it may contain information that is not current.