



Benefit Trends

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Nonqualified Deferred Compensation Under Section 409A *How the New Rules Affect Your Business Now and in the Future*

President Bush signed the American Jobs Creation Act of 2004 into law on October 22, 2004. The Act adds Section 409A ("Inclusion In Gross Income of Deferred Compensation Plans") to the Internal Revenue code of 1986, as amended, and tightens the tax laws regarding nonqualified deferred compensation plans and other individual group arrangements deferring recognition of compensation. Section 409A does not replace other doctrines previously used to regulate nonqualified deferred compensation arrangements, such as the constructive receipt doctrine, the economic benefit doctrine and the provisions of Section 83.

What the New Rules Mean

Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. The participant also must pay an additional tax of 20 percent of the compensation, which is required to be included in gross income. Interest is imposed at the underpayment rate plus 1 percent and is applied to the underpayments that would have occurred had the compensation been includible in gross income for the taxable year in which deferred. Penalties are imposed upon the service provider, even though the service recipient may cause the error.

- The term "nonqualified deferred compensation plan" means any plan that provides for deferral of compensation, not limited to employer-employee arrangements that may apply to independent contractors and arrangements between a partner and a partnership.
- A "plan" includes any agreement, method or arrangement (including those that apply to one person or individual group), whether or not it is subject to ERISA. Generally, there is a deferral of compensation where the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received in gross income and that is payable to the service provider in a later year.
- Arrangements generally subject to Section 409A are elective salary deferral plans, bonus deferral plans, supplemental executive retirement plans (SERPs), excess benefit plans, Section 457(f) plans of tax-exempt and governmental employers, discount stock options, restricted stock units, phantom stock plans and certain severance arrangements.

Section 409A generally is effective with respect to amounts deferred after December 31, 2004. Section 409A also is effective with respect to amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. Amounts that are not subject to Section 409A are considered "grandfathered," but remain subject to the constructive receipt doctrine, the economic benefit doctrine, etc. The portion of the participant's account balance that is earned and vested as of December 31, 2004, plus subsequent earnings, is the grandfathered amount. The present value of the earned and vested benefit as of December 31, 2004, to which the participant would have been entitled had he or she voluntarily terminated without cause on that date and received a full payment of benefits on the earliest possible date allowed under the plan is the grandfathered amount.

Plan sponsors have until December 31, 2005, to amend plans subject to Section 409A. Plans must be operated in accordance with Section 409A and *Notice 2005-1* in 2005. To the extent guidance is not provided, taxpayers should interpret Section 409A with a good faith, reasonable interpretation. With any interpretation and to determine how these new rules might affect you and your company with existing and future plans, you should consult legal counsel.

Amending an arrangement on or before December 31, 2005, to terminate the arrangement and distribute benefits will not be treated as a material modification, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs. For periods ending on or before December 31, 2005, an election as to the timing and form of payment under a nonqualified deferred compensation plan that is tied to a qualified plan will not violate the timing and form of distribution rules of Section 409A. A plan that provides severance pay benefits and is either collectively bargained or covers no key employees, as defined in Section 416(i) is not required to comply with Section 409A, during the 2005 calendar year.

Under Section 409A, the plan may be amended to provide for new payment elections with respect to amounts deferred prior to the election, provided that the plan is so amended and the participant makes the election on or before December 31, 2005.

For more information on nonqualified deferred compensation, contact C. John Weber III at Hubbard Bert Karle Weber, Inc. at 814/453-3633 or weber.cj@hbkw.net