

**TREASURY ISSUES CLARIFICATION OF
TRANSITION RULES FOR §409A**
Notice 2005-1 Revised

On January 5, 2005, the Treasury Department released an Announcement describing clarification of two items in the transition rules provided in Notice 2005-1. The Notice has been republished to incorporate these changes. Notice 2005-1 was the first in what is expected to be an extensive series of guidance releases concerning the nonqualified deferred compensation rules in new Internal Revenue Code §409A. (For a more detailed discussion of the contents of Notice 2005-1, please refer to Clark Consulting's *Executive Benefits Bulletin* of December 22, 2004).

Clarification on New Payment Elections.

Q&A-19 of Notice 2005-1 describes the conditions under which a plan adopted before December 31, 2005 may be operated and amended without violating the provisions of §409A. In subpart (c) of the answer to that question, the Notice provides that a plan may be amended to permit participants to submit new payment elections for amounts subject to §409A (including amounts deferred prior to the date of the payment election). The new payment election will not be treated as a change in the form and timing of payment for amounts subject to §409A (including amounts deferred prior to the date of the payment election), and therefore, the payment will not be subject a 5-year delay, provided that the plan is amended to incorporate this payment election and the participant makes the election on or before December 31, 2005. The Announcement issued on January 5, 2005, clarifies that, in addition, the new payment elections for these amounts will not be treated as an impermissible acceleration of payment under §409A. For your convenience, below is a comparison of Q&A-19(c), as written in the initial version of Notice 2005-1 released December 20, 2004, to the language in the clarification released January 5, 2005.

Q&A-19(c)

A-19(c) Payment elections. With respect to amounts subject to §409A, the plan may be amended to provide for new payment elections with respect to amounts deferred prior to the election and the election will not be treated as a change in the form and timing of a payment under §409A(a)(4) **or an acceleration of a payment under §409A(a)(3)**, provided that the plan is so amended and the participant makes the election on or before December 31, 2005. Similarly, an outstanding stock option or stock appreciation right that provides for a deferral of compensation subject to §409A may be amended to provide for fixed payment terms consistent with §409A, or to permit holders of such rights to elect fixed payment terms consistent with §409A, and such amendment or election will not be treated as a change in the form and timing of a payment under §409A(a)(4) **or an acceleration of a payment under §409A(a)(3)**, provided that the option or right is so amended and any elections are made, on or before December 31, 2005.

Bold = Insertion to initial version of Notice 2005-1

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Clarification on Termination of Plan Participation/Cancellation of Deferral Elections.

Q&A-20 of Notice 2005-1 provides transition relief with respect to termination of participation in a plan and certain cancellations of deferrals by participants. Under this transition relief and at the employer's discretion, a plan may be amended to allow a participant to terminate participation in the plan or cancel an outstanding deferral election with regard to amounts deferred subject to §409A. There is no requirement that the opportunity to terminate participation in a plan or to cancel a deferral election be granted to participants, or that if granted, this opportunity be granted to all plan participants. If the employer chooses to offer one of these opportunities (i) the termination or cancellation must occur during 2005, (ii) a plan amendment reflecting the opportunity must be enacted and effective on or before December 31, 2005, and (iii) the amounts subject to the termination or cancellation must be includible in income of the participant. The Announcement clarifies that this relief "also applies to deferrals prior to 2005 that are subject to §409A (and that otherwise meet the conditions for the transition relief), and further clarifies that the amounts subject to the cancellation or termination must be includible in income in "calendar year 2005, or if later, the taxable year in which the amounts are earned and vested (as defined in Q&A 16)." For your convenience, below is a comparison of Q&A-20, as written in the initial version of Notice 2005-1 released December 20, 2004, to the language in the clarification released January 5, 2005.

Q&A-20

A-20 (a) Plan Amendment. A plan adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan or cancel a deferral election ~~with regard to amounts deferred subject to § 409A~~, without causing the plan to fail to conform to the provisions of §409A(a)(2), (3) or (4) ~~with respect to amounts deferred after December 31, 2004~~, provided that (i) the amendment is enacted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includible in income of the participant **in the calendar year 2005 or, if later,** in the taxable year in which the amounts are earned and vested (as defined in Q&A 16).

Bold = Insertion to initial version of Notice 2005-1

Strikethrough = Deletion from initial version of Notice 2005-1

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The significance of this expansion of Question 20 to include “deferrals prior to 2005 that are subject to §409A” requires further explanation. For example, by offering the termination right for pre-2005 deferrals, the affected participants’ balances would become subject to §409A (because simply offering the right would be a “material modification” of the plan, even if the participant chooses not to exercise the right). As these amounts would be subject to §409A, they would be eligible for the transition relief for termination of participation/cancellation of deferral elections provided in Question 20, based on the clarification.

Clark Consulting comment:

Plan sponsors that wish to provide this right to terminate participation as to amounts deferred on or before December 31, 2004, should proceed with caution, as there is a potential trap for the unwary. By merely offering this termination right to any participant, there will be a material modification to such participant’s deferrals---even if the participant chooses not to exercise the termination right. Those amounts would then be subject to the requirements of §409A (i.e., grandfathering would be lost). In other words, if a participant is offered the opportunity to terminate participation in a plan for otherwise grandfathered amounts, but the participant chooses to remain in the plan, the participant’s entire balance would be subject to §409A solely as a result of being offered the termination right. This analysis is consistent with comments made by Bill Sweetnam and Dan Hogans of the Treasury Department on a January 6, 2005 teleconference with members of the American Bar Association.

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