

Summary of Key Deadlines under Notice 2005-1

Employers' Reference for Timely Transition to the Requirements of §409A

As you are aware, the Treasury Department has issued initial transition guidance concerning the nonqualified deferred compensation rules contained 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 Bulletins* of December 22, 2004, and January 7, 2005). Importantly, Notice 2005-1 contains several key deadlines in order for employers to make a timely, and compliant, transition of an existing nonqualified deferred compensation arrangement to the new requirements of §409A. Some of these key deadlines are described below. In addition, a chart summarizing these deadlines is included below – *See Figure 1 on page 5, "Transition to §409A - Key Dates under Notice 2005-1."*

JANUARY 1, 2005 – "GOOD FAITH" OPERATIONAL COMPLIANCE REQUIRED

As part of a compliant transition for an existing nonqualified deferred compensation arrangement, the plan must be operated in good faith compliance with the provisions of §409A and the Notice beginning January 1, 2005, for amounts that are subject to §409A.

MARCH 15, 2005 – DEADLINE TO INCREASE DEFERRAL ELECTIONS (OR MAKE NEW DEFERRAL ELECTIONS IF NOT YET MADE)

As part of Notice 2005-1, the Treasury department has provided a limited exception to the requirements of §409A regarding the timing of initial deferral elections. Specifically, the Notice (Q&A 21) provides that for deferrals subject to §409A that relate all or in part to services performed on or before December 31, 2005, the requirements of §409A relating to the timing of elections will not apply to any elections made on or before March 15, 2005, provided that (i) the amounts to which the deferral election relate have not been paid or become payable at the time of election; (ii) the plan under which the deferral election is or was made was in existence on or before December 31, 2004; (iii) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005; (iv) the plan is otherwise operated in accordance with §409A for amounts subject to §409A; and (v) the arrangement is brought into documentary compliance by December 31, 2005.

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Treasury initially indicated publicly that the limited exception above should be construed narrowly – i.e., that the intent was to only provide relief for employers whose taxable year and bonus plan is based on a fiscal year rather than a calendar year. However, Bill Sweetnam, Benefits Tax Counsel at the Treasury Department, and Dan Hogans, an Attorney-Advisor for the Treasury Department, recently made comments as part of a Q&A session during an American Bar Association teleconference clarifying that this transition relief also applies to employers whose taxable year is based on a calendar year.

Clark Consulting comment:

- Many tax practitioners have interpreted the transition relief provided in Q&A-21 as an extension of the enrollment deadline (which typically ends no later than the end of the calendar year). Under this interpretation, the transition relief would permit employers to allow participants to make new deferral elections (for those participants who have not previously submitted deferral elections) or to increase existing deferral elections, provided the elections are made by March 15 in accordance with the requirements described above. This interpretation is consistent with comments made by Bill Sweetnam and Dan Hogans of the Treasury Department.
- Bonuses earned in 2004 and payable in 2005 will be eligible for deferral into a nonqualified deferred compensation plan that is subject to §409A due to this transition relief, provided the requirements above are met. Without this relief, these amounts could not be deferred, as the new rule regarding the timing of deferral elections would not be satisfied.
- This transition relief applies only to deferral arrangements “in existence” on or before December 31, 2004. The Notice provides that an arrangement will be treated as in existence before December 31, 2004, only if there was written plan document that (i) identified a specific type or amount of compensation subject to the plan, and (ii) allows for participants to elect to defer compensation beyond the taxable year in which the amount otherwise would have been payable. Therefore, this relief does not apply to new plan sponsors (i.e., companies that did not have a deferral arrangement in existence on or before December 31, 2004.).

JUNE 30, 2005 – DEADLINE TO SUBMIT ELECTIONS TO DEFER “BONUS COMPENSATION” ATTRIBUTABLE TO SERVICE PERIODS ENDING 12/31/2005

Until additional guidance is issued, a deferral election for “bonus compensation”, which is based on services performed over a period of at least 12 months, will be treated as meeting the requirements of §409A for performance based compensation. As a result, bonus compensation will qualify for the performance-based compensation exception to the deferral election timing rule, and deferral elections may be made as late as 6 months before the end of the service period. For purposes of this transition relief, “bonus compensation” includes compensation for which (i) the payment of the compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria, and (ii) the performance criteria are not substantially certain to be met at the time a deferral election is permitted. (Q&A-22).

Clark Consulting comment:

- It is expected that during 2005, Treasury will issue additional guidance that sets forth more restrictive requirements for “performance-based compensation”. Following the release of these more restrictive requirements, employers will not be able to rely on the interim definition of “bonus compensation” above for purposes of determining eligibility for the more lenient timing rule. (Q&A-22)
- Employers unsure about whether a bonus/incentive program will qualify as “performance-based compensation” should solicit elections to defer 2006 bonus compensation (bonus earned in 2005, payable in 2006) no later than March 15, 2005 – the deadline for the transition relief provided in Q&A-21.

DECEMBER 31, 2005 – DEADLINE FOR COMPLETING PLAN DOCUMENTS AND FOR ALLOWING PARTICIPANTS TO TERMINATE PLAN PARTICIPATION, CANCEL DEFERRAL ELECTIONS, OR MAKE NEW PAYMENT ELECTIONS.

Documentary Compliance. Employers have until December 31, 2005, to bring their plan documents into compliance with the requirements of §409A. However, during a December 22, 2004, teleconference sponsored by the AALU, Treasury's Bill Sweetnam, in discussing Notice 2005-1, cautioned that plan sponsors should not attempt to bring documents into compliance until after further guidance is released.

Opportunity to Make New Payment/Distribution 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 Q-19, 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. In addition, these new payment elections will not be treated as an impermissible acceleration of payment under §409A.

Clark Consulting comment:

- The Treasury guidance provides employers with adequate time to come into documentary compliance with the legislation. Treasury has informally indicated that this may be accomplished by either revising existing plan documents or creating new plan documents that comply with the legislation.
- To comply with the requirements of §409A, plan documents must incorporate provisions that fully reflect the manner in which the plan has been operated during 2005, including any transition relief made available to plan participants (or utilized by the employer) during 2005 (e.g., the ability of participants to increase deferral elections or make new elections by March 15, 2005; the right of participants to terminate plan participation or cancel deferral elections; the opportunity to make new payment elections, etc.).

Termination of 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 or, if granted, that the 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 January 5, 2005, Announcement from Treasury clarified 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 clarified 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)."

Clark Consulting comment:

- Employers who wish to provide the right to terminate plan participation or to cancel a deferral election 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. Importantly, if a participant is offered the opportunity to terminate participation in a plan which includes 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.
- Employers who amend their plans to allow a participant to terminate plan participation or to cancel a deferral election should be aware of, and plan for, the payroll and recordkeeping issues that will accompany "reversing" the affected deferral (e.g., adjusting employment tax reporting and withholding obligations, unwinding the deferral from the participant's account balance, etc.). The window of opportunity for participants to make these choices may need to be limited and timed to expire sufficiently before year-end to enable the employer to make the necessary adjustments.

