

New Deferred Comp. Rules May Go Too Far, Practitioners Say

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The American Jobs Creation Act of 2004 (P.L. 108-357) makes dramatic changes to the rules governing nonqualified deferred compensation arrangements. Some practitioners question, however, whether the new law is too broad. The new rules will become effective for all amounts deferred after December 31, 2004.

The new rules are contained in new code section 409A. Section 409A supplements the old nonqualified deferred compensation rules by adding new rules restricting a taxpayer's ability to implement deferred compensation plans in three key areas: distributions, accelerations, and elections.

But many practitioners, including Andrea S. Rattner, partner at Proskauer Rose LLP in New York, question what constitutes compensation.

"Compensation is sort of a broad, nonspecific term in a lot of ways," Rattner said, adding that she thinks Congress and Treasury are concerned with real and perceived abuses of compensation plans. "I think that in a lot of ways the conference report and the statute are intentionally vague and intentionally broad," she said. "I think now is the time for Treasury to come down and give us some parameters as to what is compensation."

'Treasury people call this legislation a sea change, but I think it's probably more accurate to call it a tsunami,' Oliphant said.

The statute does make clear, however, that bona fide vacation leave, sick leave, compensatory time, disability pay, death benefit plans, qualified retirement plans, and section 403(b) plans are all excepted from the new rules. Even so, the new law has created a stir among practitioners, who want concrete rules in a once highly unregulated area.

"It's obviously a very significant change in the law of executive compensation," said Jed W. Brickner, partner at Latham & Watkins LLP in New York. "However, I think that the amount of panic being generated within the profession is probably not completely justified."

"Treasury people call this legislation a sea change, but I think it's probably more accurate to call it a tsunami," said Fred Oliphant of Miller & Chevalier Chartered.

New Restrictions

Deferred compensation may be distributed only following one of six events, as provided in section 409A(a)(2): (1) separation from service; (2) disability; (3) death; (4) a specified date of deferral under the arrangement, but not an event; (5) a change in ownership or effective control of the corporation (or ownership of a substantial amount of the corporation's assets); or (6) an unforeseeable emergency.

Many practitioners said they are concerned because the new rules fail to define "separation from service" in new section 409A. Government officials have indicated that the term will not cover all terminations of employment. Treasury and the IRS are expected to clarify what constitutes separation from service in future guidance.

The new rules also generally ban acceleration of deferred compensation payments, except as authorized under future regulations.

'We don't even know what it means to be deferred compensation,' Weiser said.

Generally, the initial election to defer compensation for service performed during a tax year must be made before the close of the preceding tax year. There are two exceptions to that rule: (1) for the first year in which a participant becomes eligible to participate in a plan, the election may be made regarding service to be performed after the election within 30 days after the date the participant becomes eligible; and (2) for any performance-based compensation based on services performed over a period of at least 12 months, the election may be made no later than 6 months before the end of the period.

Generally both the time and form of distributions must be designated at the time of the initial deferral election. Under section 409A(a)(4)(C), however, changes that delay or alter the form of payment are permitted if three requirements are met.

Funding deferred compensation arrangements may also prove to be more difficult than in years past. The new rules restrict arrangements in which assets are set aside in an offshore trust to pay deferred compensation under a nonqualified plan. Also, assets that become restricted to the payment of deferred compensation in connection with a change in the employer's financial health are now taxable to the participants when the plan first provides that assets will become restricted or when the assets become restricted, whichever is earlier.

The new rules require reporting of deferred compensation to the IRS on Form W-2 or Form 1099.

Amounts deferred should be reported for the year of deferral, even if the compensation itself may not yet be taxable.

"Certainly the rules appear to be written so broadly as to cover a wide variety of arrangements that we do not typically think of as deferred compensation," said Carol A. Weiser, partner at Sutherland Asbill & Brennan LLP. "I think we may be getting some sense from Treasury that some of those situations may be getting carved out, but we're not entirely sure yet, and it's leaving everyone kind of nervous about what that means We don't even know what it means to be deferred compensation."

"It seems to me you read the rules and it seems somewhat straightforward on its face, but when you dig beyond the simple words of the statute and try to apply it in practice, we end up finding that there are significant amounts of issues and that it has a significant impact on many types of arrangements that probably were not intended by Congress," said Rattner.

Guidance Coming

Treasury and the IRS will be releasing the first of several guidance projects addressing executive compensation rules by mid-December, William F. Sweetnam Jr., Treasury tax benefits counsel, told Tax Analysts.

"Congress told us to get the guidance out within 60 days of the signing of the bill, which means December 21 — we're hoping to get it out in the first half of December," Sweetnam said. According to Sweetnam, Treasury will be folding the 90- and 60-day guidance together in December.

"There are a lot of questions that need to be answered, and it's a very complicated statute," Sweetnam said. "We can't get all that guidance done in 60 days. Instead we're trying to get out the transition guidance and give people an idea of what deferred compensation is, and then address some of the other issues later on in other guidance."

Treasury's first round of guidance will address what constitutes nonqualified deferred compensation and will provide broad transition rules for plan sponsors so that their deferred compensation plans don't automatically fail the new rules, because there was no way to know the statutory change was coming, said Sweetnam. He also said Treasury will be offering transition relief regarding restrictions on distribution options by allowing plan sponsors to get their documents in compliance with the new rules, and it hopes to address whether severance pay is a form of deferred compensation covered by section 409A.

The statute also provides an exception to the election rules for performance-based compensation

paid within six months before the end of a performance period — a provision that has been questioned by some practitioners. Sweetnam said Treasury will also be addressing in the December guidance what it means to have performance-based compensation.

"We're trying to be very helpful in these rules," Sweetnam said. "This is a major change in how you tax deferred compensation, and people don't have a lot of time to understand the rules or comply with the rules."

"If Sweetnam and his colleagues are to be believed, the changes are not going to be required in a way that is going to interfere with the normal running of corporate human resources departments," Brickner said. "The statute requires Treasury to give us timely guidance — Sweetnam and his people have done an impeccable job in getting out into the benefits community, hearing practitioners' concerns, and responding to them in very useful ways."

'There are a lot of questions that need to be answered, and it's a very complicated statute,' Sweetnam said.

Even so, Sweetnam has reiterated over the last several months that Treasury plans to be "generous" in the transition relief.

"We're going to give people the ability to correct their elections and correct their plan documents so that we're not going to force them into being noncompliant," Sweetnam said. "We're giving them the ability to change their documents to become compliant."

"The transition is going to generate a huge amount of work for both lawyers and the IRS," said Mims Zabriskie, partner in the Philadelphia office of Morgan Lewis & Bockius LLP. "Because of the broad effect of this legislation, there are going to be a lot of questions about the many different types of arrangements that this legislation affects. I think if they had a transition rule that grandfathered in any existing contracts, [it] would have been a cleaner break." Now all existing contracts will have to be renegotiated to comply with section 409A.

"The law itself is not so bad," said Howard Clemons, partner at Shaw Pittman. Despite not agreeing with all of the provisions, Clemons predicted that many of them will get fixed in regulations. "But the law applies to a lot of common transactions that are not abusive," Clemons noted. "Taxpayers should be able to have certainty in what they are doing, and this law creates great confusion, uncertainty, and disruption in typical business activity just because of the way it was enacted. . . . It's

a criticism of more of the process than the ultimate law that they will end up with."

"They're trying to address some things that Congress thought was abusive in cases like Enron," Brickner said. "Whether this is an overreaction or not may be a question for another day."

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"I think that this is not a cause for huge panic or dislocation," Brickner added. "People are going to have to change their procedures somewhat, but life will go on."

Deferred Comp Gumbo

Although many practitioners predict that Treasury and the IRS will include stock appreciation rights (SARs) and stock options in the definition of nonqualified deferred compensation in their guidance, plain vanilla stock options will not be considered deferred compensation subject to the new rules, Sweetnam said. He said Treasury views stock options — unlike SARs, which are promises to pay — as the transfer of property, with the option being the property component.

"That has left open whether discounted stock options or other forms of deferred compensation that mimic the economic performance of a stock option will be subject to the rules," said Sweetnam. "We will clearly state in our first round of guidance whether these things are in or out of deferred compensation." Sweetnam also assured Tax Analysts that Treasury will convey whether SARs are to be treated as deferred compensation arrangements under section 409A.

Because the new law applies to any nonqualified plan that provides for the deferral of compensation, many practitioners question the reach of the laws to existing arrangements.

"This potentially covers a very broad spectrum of arrangements — including things not usually thought of as deferred compensation, such as severance plans and restricted stock," said Adam B. Cohen of Sutherland Asbill & Brennan LLP. To ensure that the statute does not inadvertently disrupt normal business arrangements that were not the target of the legislation, Treasury could define "deferral of compensation" in a way that excludes an amount paid in the same year in which it vests, suggested Cohen. "A definition along these lines would exclude most severance plans, restricted stock grants, and similar arrangements from coverage under the new law," he said.

Depending on how broadly it is read, there is a risk that section 409A will interfere with other valid business practices, said Kurt L.P. Lawson, partner at Shaw Pittman LLP in Washington. "If stock and stock options are treated differently from phantom stock and SARs, it could encourage taxpayers to pick one over the other solely for tax reasons and destroy the level playing field between them that is being created by the gradual adoption of FAS 123."

Unless regulations provide otherwise, SARs are now no longer useful, said Clemons. "They may fix it, but it's still a disruption," he said. "Even if they ultimately fix it, who knows when that will be?"

Rattner said that many practitioners are also struggling with section 409A's potential implications for restricted stock and that the security by its nature establishes a deferral because no income is derived at the time of the stock grant, unless someone makes an election under section 83(b).

Liazos said Treasury implemented what proved to be a problematic section 83 carveout scheme for nonprofits under section 457.

"One could make the argument that upon the vesting of a restricted stock payment, where that vesting is tied to a fixed vesting schedule, then you would comply with the rules because the rules allow for a distribution at a specified time," said Rattner. "That seems to work, but then you get into issues with acceleration and change of control — and we don't know what that means yet."

According to Zabriskie, the statute's applicability to SARs, discounted stock options, phantom stock, and severance pay is likely an unintended consequence and lacks valid policy rationale. SARs are often used by subsidiaries, Zabriskie said, to provide equity-like incentives for a wide range of employees — not just management. To help middle management feel like part of the team, companies often provide SARs. "I think that was a very valid plan design that now we can't have anymore," she said.

But section 409A has no carveout for section 83, and many practitioners were quick to point out why.

"There's a reason for that," said Andrew C. Liazos, partner with McDermott, Will, & Emery LLP in Boston. Liazos said Treasury implemented what proved to be a problematic section 83 carveout scheme for nonprofits under section 457. Under the old section 457 rules, many opportunistic employers quickly took advantage by offering discounted mutual fund options as an alluring substitute for compensation. Liazos said that although it appears

as if Treasury wanted to protect against similar abuses with section 409A, he finds it ironic that those issues reinvigorate the same debate started in the 1960s, in that it makes one think about what deferred compensation is, particularly in the analysis of restricted stock and SARs.

"The statute covers way more types of compensation arrangements than one may have thought would constitute deferred compensation," said Brickner, noting that below-market stock options are likely to be added to that list. "They're also making it harder to maintain control over when the executive will receive money."

Nonprofit Tug of War

But tax-exempt and government employers may get hit the hardest by the new rule changes, said Peter J. Marathas, partner at Mintz, Levin, Cohen, Ferris, Glovsky and Popeo, P.C., noting that the new rule's grandfathering provision appears to be problematic. Only amounts earned and vested before January 1, 2005, with no material modifications after October 2004, will be grandfathered under the old law. "We're waiting to see guidance from the IRS as to what all that will mean, including what it means to be grandfathered," said Marathas.

But even if executive compensation plans have been well designed by practitioners who know what they are doing, those amounts won't be earned and vested until they are finally payable, noted Marathas. "This is because of a fundamental distinction between the general rules that apply to nonqualified deferred compensation arrangements sponsored by private companies and the rules that apply to the tax-exempt and state government world, under section 457(f)," Marathas said. Once amounts become vested in the nonprofit world, they are reflected as income under section 457(f).

In the for-profit world, when section 457(f) does not apply, an executive's deferred compensation plan can still be maintained after its vesting period in a plan in which it can later be distributed. Marathas stressed that the concept of "earned and vested" in section 409A remains the critical tension between the rules.

"If the IRS doesn't do something, then I don't see how any tax-exempt or university plan that is out there is going to get any relief under the transition rules," Marathas said. "If those plans are properly designed, all of those monies will be unearned and unvested by December 31, 2004."

"Things you might do to fix a 409A problem could give you a problem under 457(f)," said Michael J. Album, partner at Proskauer Rose LLP in New York, of distribution restrictions under section 409A. "Sweetnam has apparently taken the position that you will be subject to the most onerous position."

"This offends me, because these were perfectly legitimate contracts that were entered into prior to the change in the law, and along comes Congress, which fundamentally impairs that contractual arrangement between employers and many [university and college] headmasters," said Marathas. "It's bothersome to me, but it's something we'll just have to fix — it's a real problem."

"You don't see anything that says tax-exempt employers are exempt from these rules, and the legislative history just says that the Treasury is supposed to interpret the rules for tax-exempt," added Eleanor Banister, partner at King & Spalding LLP. "That part is troublesome for businesses."

Unintended Consequences?

Many practitioners agree that section 409A is broadly constructed, and Treasury and the IRS have indicated that they plan to interpret it broadly as well. Still, companies are struggling to understand how the rules in 409A will apply to arrangements that are not plain vanilla deferred compensation arrangements, such as severance pay, long-term incentive compensation, SARs, stock options, and plans subject to section 457(f).

"Though it was enacted and taxpayers must deal with it, this seems to be a statute that is still largely in search of a rationale," said George Bostick, partner at Sutherland Asbill & Brennan. Bostick said that, despite a modest amount of estimated revenue assigned to the provision, he believes the deduction matching rules of sections 83(h), 404(a)(5), and 404(b) ensure that, unlike qualified plans, there will be little if any tax subsidy here. "This is not an articulated or particularly plausible rationale for section 409A," Bostick said.

'Sweetnam has apparently taken the position that you will be subject to the most onerous position,' Album said.

Bostick was quick to point out that other concepts that were noted in the Joint Committee on Taxation's staff report on Enron can reasonably be viewed as the genesis of the effort. The report noted that Enron executives had deferred about \$150 million in compensation and had received accelerated distributions of about \$53 million in the weeks preceding Enron's bankruptcy under the terms of the applicable nonqualified deferred compensation plans. "In a context where rank-and-file employees were losing the value of 401(k) accounts that were, because of an administrative blackout period, locked into company stock, this seems fundamentally unfair," said Bostick. Even so, Bostick said

arithmetic suggests that Enron executives (at least some of whom were presumably without fault) must have lost nearly \$100 million that they might have otherwise received as current compensation. "If the \$53 million accelerated was in fact paid in the weeks before bankruptcy, why would it not be recoverable from them under the bankruptcy laws?" asked Bostick. "The net results of the Enron deferrals are not ones that would prompt many practitioners to encourage their clients to mimic Enron's plans," he said.

From the Enron example, however, the JCT report also concluded that current rules allowed executives too much security and control over their deferred compensation and, by doing so, undermined the qualified plan system, Bostick said. "No evidence was offered, or apparently required, for this far from self-evident proposition," Bostick contended.

"Does the legislation really accomplish the goal it was set out to achieve?" Liazos asked. "I think the answer to that is really unclear."

Sweetnam said he agrees that part of Congress's rationale for enacting section 409A was in response to several accounting scandals, including Enron.

Sweetnam said he agrees that part of Congress's rationale for enacting section 409A was in response to several accounting scandals, including Enron. "That's part of it," Sweetnam said. "The other part is there were not a lot of rules that were set out prior to Enron — Congress stopped the IRS and Treasury from issuing guidance on deferred compensation back in 1978." When Congress saw what was happening with Enron and saw what the rules were, it realized they weren't very clear, Sweetnam said.

"It is a big change from before, because you didn't have legislation," Sweetnam said. "The Internal Revenue Code didn't address deferred compensation."

Still, some practitioners do not believe the abuses identified in the JCT report were abuses of tax law. "The most troubling practice identified in the Enron report and targeted by section 409A — the ability of executives to withdraw their deferred compensation on the eve of bankruptcy while other stakeholders are left with nothing — is a corporate law and bankruptcy abuse, not a tax abuse," said Lawson.

Relying on court precedent, Lawson explained that taxpayers are allowed to use the cash method of accounting, and courts have consistently recognized that this means what it says: An individual is

not taxed until he or she has cash in hand or something close to it. "Few of the practices targeted by section 409A violate the letter or spirit of that rule," said Lawson.

Lawson admits, however, that the IRS has been at a disadvantage in policing how taxpayers can apply the cash method to deferred compensation, because section 132 of the 1978 Act prohibits it from issuing general guidance on nonqualified deferred compensation.

"Most benefits lawyers think that the proper solution to that problem would have been for Congress to repeal section 132 [of the 1978 Act] and the IRS to increase enforcement of the existing rules, as it had already begun to do," said Lawson. "Furthermore, section 132 probably did not prevent the IRS from challenging other practices targeted by section 409A — such as overseas trusts and very expansive interpretations of substantial risk of forfeiture — using its regulatory authority under sections 83, 402, and 457."

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"It was like we were in a frontier town — there was shooting on the streets and people getting dead all over the place on these things," Marathas said of the "rowdy" lay of the land at the time. The lawless world of executive compensation led to many extreme positions, said Marathas, such as executives deferring large amounts of money and still effectively controlling it. "Because they had use of the income, it should have been taxable," Marathas said. "But it was left alone. . . . Then WorldCom, Enron, and Delta came along."

"The result of this is an overbroad [law] and gives the IRS tremendous authority to draft regulations that will be similarly overbroad," Marathas said. "Now we're waiting to see what they're going to do."

Was There Another Way?

During the congressional investigation of Enron, Congress supplemented its "security and control" rationale with a theory that existing rules were not clear enough and that a legislative solution was required, Bostick said. Many practitioners agreed with Bostick that the rules were unclear, and the government had at least two alternative solutions available that would have allowed careful development of "reasonable" rules for different types of arrangements.

First, several practitioners suggested that Congress could have repealed the "freeze" on IRS reg guidance dictated by section 132 of the Revenue Act of 1978. That approach, when suggested by Treasury, seems to have made no one happy, according to Bostick. Another alternative to the new section 409A rules would have been authorizing the IRS to implement a project that has been on the business plan for years: conforming to the case law its guidelines for the circumstances in which the IRS would issue rulings on deferred compensation and current types of plans.

Several practitioners suggested that Congress could have repealed the 'freeze' on IRS reg guidance dictated by section 132 of the Revenue Act of 1978.

"Either [alternative] might have allowed the IRS to be more than an occasional player in the non-qualified deferred compensation world and thus strongly influence the shape of that world," Bostick said.

Instead Congress enacted a statute that, while applying to a broad spectrum of arrangements, effectively codifies the old ruling guidelines that were previously supposed to have been revised, is written largely in terms that reflect elective defined contribution deferral arrangements, and often does not fit other structures well, according to Bostick and others. "At the risk of a cheap shot, one might ask whether a statute whose fundamental definition holds that, subject to limited exceptions, a 'non-qualified deferred compensation plan' means 'any plan that provides for the deferral of compensation' really adds clarity," said Bostick.

"Instead what we got is a statute that puts all sorts of artificial limitations on what can be done, and in addition to somewhat targeting what was perceived to be abusive, such as haircut provisions and the like, it also raises questions about compensation packages that were always considered to be appropriate and well within the meaning of existing tax rules," Liazos said.

Liazos said he believes part of the answer may lie in the Congressional Budget Office's score of the bill. (For the CBO revenue estimates, see *Doc 2004-21788* and *2004 TNT 219-59* or *Doc 2004-20950* or *2004 TNT 209-8*.) "When CBO marked up this bill, it was a revenue gain, versus a bill that would undo the 1978 Revenue Act, which wasn't marked up to raise any revenue," Liazos said. "This legislation, when you think about it, is a commentary about how much of what we actually see is driven by the numbers, which in many cases might be viewed to

be less than solid. One wonders whether this was the right way to attack the problem."

But Lawson sees it differently. "Clients generally think section 409A is an overreaction to a small number of abuses and are a little surprised to see it coming out of a Republican Congress," he said. "I think it's a good example of the complexity that results when the code is used to pursue nontax policies, and in that respect has a lot in common with the golden parachute rules and the \$1 million cap."

"I certainly understand the IRS's desire to have rules — and in the long run, it's actually better to have rules," Zabriskie said. "I do think there may have been some perceived abuses, but in any event, I think this legislation will go way beyond whatever the perceived issues were. Be that as it may, I think it's a good thing to have rules."

Grandfather Time

Many practitioners remain concerned by the statute's "unusual" grandfather provision. Section 409A itself provides, as a general effective date, that the new rules apply to "amounts deferred after December 31, 2004." Several practitioners noted that the Jobs Act conference report interpreted that clause as meaning it does not apply to amounts that were both "earned and vested" before 2005. If "earned and vested" is interpreted as meaning that no further services are required in order to be entitled to the compensation, as many practitioners fear, rights that now exist and that may have long existed under binding contracts will be affected.

Treasury and the IRS plan to address those issues in upcoming guidance, said Sweetnam. He also confirmed that amounts that were deferred and vested before January 1, 2005, will be grandfathered under the old rules unless the plan is materially modified after October 3, 2004.

'I think most people understand that the new rules are going to limit employee flexibility under deferred comp plans,' Oliphant said.

"We will give guidance on what is a material modification so that people will know whether they are under the old rules or under the new rules," Sweetnam said.

Still, Lawson said he believes Treasury and the IRS will interpret the grandfather rule narrowly and will apply it on a plan-by-plan basis.

"Many companies are avoiding doing anything with their existing plans that involves an exercise of discretion, including routine tasks like authorizing

distributions, for fear of losing grandfather protection for the entire plan," Lawson said.

Problems in Practice

Sweetnam said he thinks that although some people are going to find they must make many changes in their current compensation packages and probably won't like that, many people will find it easy to comply with the new rules.

"Most people I know are just continuing to find instances where these rules can reach out and touch things that you never dreamed would be treated as executive compensation," said Banister.

Without regulations, practitioners including Banister are admittedly confused, and some think the timing could not be worse for their practices. Banister said that because the regulations are coming out at the end of the year, when most people are handling their elections for deferred compensation for the following year, the changing rules that have yet to be clarified only exacerbate their concerns. "That's a little unsettling," Banister said. "It's a bad place for business to be in — and certainly advisers, because you just have to tell them to be patient and wait on the guidance."

Practitioners are also concerned about the effect of the new distribution restrictions and antiacceleration rules on employer flexibility to respond to changes in circumstances that are not within the employer's control.

"I think most people understand that the new rules are going to limit employee flexibility under deferred comp plans," Oliphant said. "But I think an important point that is sometimes overlooked is the extent to which words have the potential to limit significantly employer flexibility to respond to changes in circumstances that are not within the control of the employer. I think that's going to be a hard thing for HR departments to get their head around — that they're not going to be able to respond to changes in circumstances with a quick fix — it really does tend to put them in a straight-jacket."

"Part of what is fun about executive compensation is that there haven't been as many bureaucratic rules as in qualified plans, so we have been able to be more creative and able to design programs that are tailored to provide specific incentives," Zabriskie said. "I think we can still be creative under section 409A — I don't think these rules that have been enacted are going to stymie creativity too much. But if this is only step one of a series of new rules for executive compensation, then that will definitely change the creativity."

"It disturbs existing contractual relationships in a way that is more pervasive than we typically see," Weiser said. "It's not entirely clear to us that in all

instances those were abusive situations that needed to be dealt with in that fashion."

"As a practice matter, we've had to go back to everything that we've touched as executive compensation lawyers and think of it with a 409A hat on, including things that we are doing now," added Album, who stressed the difficulty of renegotiating existing executive compensation arrangements under the grandfather provisions of section 409A. "It's extremely far-reaching — you have to do an inventory of all your existing arrangements and think about it in the context of your current arrangements," Album said.

Section 409A's potential effect on foreign plans and arrangements is also a "great unknown," Oliphant emphasized.

"People are concerned about the potential of the offshore funding restrictions to reach legitimate arrangements, but even without regard to those special funding restrictions, just the general rules governing deferred comp have the potential to play havoc with U.S. taxpayers working abroad where they are covered by foreign plans or arrangements," Oliphant said. Difficulties are likely to arise, Oliphant predicted, because he does not expect many foreign companies to modify their deferred compensation plans — which cover mostly foreign nationals — to conform to U.S. tax rules.

"There are all kinds of arrangements that this legislation attacks that clearly were never the primary target," said Liazos. "I think you're going to continue to find employers struggling with this, in terms of what it really means for all of their plans. For the next year or so we're all going to worry about what the real breadth of the statute is."

Liazos predicts that because of section 409A most employers will opt to compensate their executives with lump sum payments, rather than gamble with the new deferred compensation scheme.

"The impact of the legislation is that it doesn't allow for accelerations, but it does allow for deferrals," Liazos said. From a practical planning perspective, Liazos said, it might be better to start with a lump sum and allow for deferral out as opposed to starting with payment at a later time and being unable to push it forward. "It's kind of an ironic result, since this legislation was designed to put executives more at risk yet may have the impact of having plans provide for sooner payments and lump sums because of the ability to defer out, and not to accelerate," Liazos said.

Employees holding several different benefits qualifying under section 409A's grandfather provision may also experience serious difficulties, said Zabriskie. The IRS has indicated, she said, that taxpayers may encounter the possibility of blowing the grandfather status of all benefits if any one of

those grandfathered benefits is modified. "I don't really understand the policy reason for that — it's just a big mess," Zabriskie said.

"You just think there would have been a better way to do this," Banister added.

Enforcement Obstacles

Enforcing the new scheme may prove to be difficult for the government, Oliphant said. "You really do wonder how these new rules are going to be enforced," he said. "Is the IRS really going to set up tax deficiencies for 200 executives because the plan's terms contain a change of control provision that doesn't quite line up with whatever definition Treasury comes up with? I think that's something people really scratch their heads over."

Many practitioners, including Oliphant, also questioned whether taxpayers and practitioners would buy into a voluntary compliance system similar to nonqualified deferred compensation plans.

"Congress hasn't been very successful in the past in its attempts to regulate compensation practices through the tax code — you really have to wonder whether we've once again entered the land of unintended consequences with this provision," Oliphant said.

"When I was at Treasury, we went to great lengths to expand the correction programs for pensions," said Treasury's former top pension official, J. Mark Iwry, now nonresident senior fellow at Brookings Institution and of counsel at Sullivan & Cromwell. "In this nonqualified area it is much harder to establish a comparable program because the IRS lacks the resources for nonqualified plans that it has in the qualified plan area."

Iwry also said the employee plans compliance resolution system allows qualified plan sponsors to correct foot faults and other mishaps without disproportionate consequences, and he noted the relatively manageable monetary sanctions that are imposed on employers volunteering to correct their plans.

"The IRS has an established program with personnel and budgetary resources for qualified plans which they do not for nonqualified," said Iwry. "If the IRS tried to set up a similar program for the correction of nonqualified plan defects, there would be nobody home." Iwry questioned whether the IRS would be willing and able to establish a new policing division for nonqualified plans.

According to Iwry, Treasury is following a different strategy in the nonqualified area by generally seeking to limit the damage from a plan defect to a single individual rather than the entire plan population.

The new rules also have no provision allowing employers to terminate a nonqualified deferred

compensation plan that has outlived its usefulness to the employer without imposing penalties on the employees, Bostick noted. Under old law, employers would frequently retain the unilateral right to terminate the plan and pay out the amounts credited. As long as distributions were made to everyone, constructive receipt was irrelevant — the participants were in actual receipt.

“Apparently out of fear that this would allow accelerated distributions as the employer neared bankruptcy (and ignoring clawbacks under the bankruptcy laws), neither the statute nor the legislative history suggests the availability of a termination exception from 409A’s no-acceleration rule,” Bostick said. “The result is that nonqualified plans become more difficult to get rid of than are qualified plans.”

Still, practitioners should comply with the new rules if they wish to avoid penalties, advised Sweetnam. Under the new rules, any deferred amount that does not comply with section 409A will be included as income with interest on the time value of the deferral. Treasury will also impose a 20 percent excise tax on the full amount of the deferral. ■