



## **New Tax Code Changes Impacting the Deferred Compensation Plans of Colleges and Universities**

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In reaction to perceived abuses in executive compensation programs, the American Jobs Creation Act of 2004 ("AJCA")<sup>1</sup> established extensive new requirements for "non-qualified deferred compensation plans." The new requirements, which are found in Internal Revenue Code Section 409A, apply in addition to existing tax rules, including those under Code Section 457(f). The requirements, and the types of arrangements to which they apply, go far beyond the abusive situations that prompted the legislation. The failure to identify arrangements subject to Section 409A, to operate them according to the new rules, or to revise the governing documents for such arrangements to conform with the new rules will result in substantial additional taxes to employees and others covered by such arrangements.

Section 409A applies to a broad range of programs for employees and other service providers, many of which have not typically been considered non-qualified deferred compensation plans. The provisions of many executive employment contracts, for example, constitute "non-qualified deferred compensation plans" within the meaning of Section 409A. Severance arrangements exempt from Internal Revenue Code Section 457(f) may also be subject to Section 409A. Because the reach of Section 409A is broad, and the consequences of failure substantial, every college or university should review its compensation arrangements carefully to determine whether they are subject to the new rules and, if so, what must be done to comply.

### **Overview of Section 409A**

Section 409A provides rules relating to several different aspects of non-qualified deferred compensation plans. These rules can be categorized as follows:

- Rules relating to when an initial election to defer compensation can be made;
- Rules limiting a person's ability to change the timing or form of deferred compensation payments, once they have been established;
- Rules limiting the circumstances under which deferred compensation can be paid;
- Rules prohibiting the acceleration of deferred compensation payments; and
- Rules prohibiting certain types of funding arrangements and practices.<sup>2</sup>

If either the documents governing a non-qualified deferred compensation plan or the manner in which the plan is operated violates any provision of Section 409A, all deferred amounts under the plan will be included in the service provider's current taxable income (to the extent not previously included in gross income), even if the service provider does not have any right to receive such amounts until a future date. In addition, the service provider will be required to pay (i) interest at the tax underpayment rate as if the deferred amounts had been taxable at the time of deferral (or, if later, when the deferred amounts were first vested), and (ii) an additional tax equal to 20% of the deferred amounts included in taxable income.<sup>3</sup>

Although the additional taxes under Section 409A are imposed on the service provider, it would be extremely imprudent for an employer to assume that Section 409A is a problem for employees that the employer can ignore without consequences. First, any program that results in significant taxation to employees before they receive payments is extremely unattractive and likely to leave employees unhappy. Second, employers are legally obligated to withhold the additional taxes imposed by Section 409A. The IRS has indicated informally that it intends to audit compliance with Section 409A at the employer level and to pursue employers that have not properly withheld taxes.

### **Effective Date of Section 409A**

The effective date of Section 409A is January 1, 2005.<sup>4</sup> Section 409A applies to (i) amounts deferred after 2004, (ii) amounts deferred before 2005 that were subject to a substantial risk of forfeiture on December 31, 2004, and (iii) amounts deferred and vested before 2005 under an arrangement that is "materially modified" after October 3, 2004. In general, a plan is materially modified if any benefit existing as of October 3, 2004, is enhanced or a new benefit is added after October 3, 2004.<sup>5</sup> A material modification need not be the result of a plan amendment. It can also result from the employer exercising its discretion under the terms of the plan.<sup>6</sup> For example, if a plan document allows the employer to accelerate vesting in its discretion, the exercise of that discretion will be a material modification, subjecting pre-2005 deferrals to Section 409A. The final regulations issued under Section 409A list a number of changes, including plan terminations, that can be made without being considered a material modification.<sup>7</sup>

If a plan provides for amounts deferred and vested before 2005, as well as amounts deferred and/or vested after 2004, the amounts deferred and vested before 2005 can be accounted for separately, in which case they will not be subject to Section 409A, unless the plan is materially modified after October 3, 2004, with respect to those amounts. Thus, an employer may bifurcate an existing plan, keeping the more flexible rules of prior law for pre-2005 deferrals not subject to Section 409A and limiting the stricter rules of Section 409A to amounts deferred or vested after 2004. In such a case, the plan is treated for tax purposes as two plans, one subject to Section 409A and the other not.

As a practical matter, many non-qualified deferred compensation plans sponsored by colleges and universities will not have grandfathered deferred amounts (*i.e.*, amounts both deferred and vested before 2005) for current employees. Because deferred amounts are taxable

when vested under Section 457(f), plans subject to Section 457(f) are frequently designed so that compensation is paid at vesting.

### **Status of Internal Revenue Service Guidance**

The final regulations under Section 409A, which were issued in April 2007, provide and/or extend certain transitional rules, which give employers considerable flexibility for revising non-qualified deferred compensation arrangements to comply with the new rules through the end of 2008. However, the final regulations do not relieve employers from the obligation of complying in good faith with Section 409A and its transition guidance from 2005 forward. In addition, unless the deadline is extended by the IRS, employers with plans subject to Section 409A will have to amend their plans not later than December 31, 2008.<sup>8</sup> Given the fact that Section 409A is currently in effect, and that plan amendments must be adopted not later than December 31, 2008, employers should evaluate their existing programs in light of Section 409A immediately, if they have not done so already.

### **Plans Subject to Section 409A**

Section 409A applies to "non-qualified deferred compensation plans."<sup>9</sup> For purposes of the statute, the term "plan" includes any agreement or arrangement, including an agreement or arrangement that covers only one person.<sup>10</sup> Thus, an employment contract may be a plan subject to Section 409A. In general, a separate plan is deemed to exist for each service provider, and similar types of arrangements for the same service provider are deemed to be a single plan.<sup>11</sup> A "non-qualified deferred compensation plan" is any plan that provides for the deferral of compensation, other than a "qualified employer plan" or a *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.<sup>12</sup> In addition, medical reimbursement arrangements that satisfy the requirements of Code Sections 105 and 106 are not subject to Section 409A. "Qualified employer plans" exempt from Section 409A include tax-qualified plans under Code Section 401(a), tax-sheltered annuity plans governed by Code Section 403(b), qualified government excess plans under Section 415(m), and eligible deferred compensation plans that satisfy Code Section 457(b).<sup>13</sup> Note that unlike with respect to Code Section 457(f), *bona fide* severance plans are not exempt from Section 409A.

A plan is considered a "non-qualified deferred compensation plan" only if it provides for "the deferral of compensation." The final regulations provide guidance as to what constitutes a deferral of compensation. "Deferral of compensation" is defined as follows:

A plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later year. . . . A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed . . . . [C]ompensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or

eliminated by operation of the objective terms of the plan, such as the application of a nondiscretionary objective provision creating a substantial risk of forfeiture . . .

<sup>14</sup>

Under this definition, by way of example, a university President's employment contract that provides that in the event the President is involuntarily terminated during the contract term, the President shall receive salary continuation until such time that the term of the contract would have ended but for the President's termination of employment, is a non-qualified deferred compensation plan subject to Section 409A.

The final regulations exempt certain short-term deferrals from Section 409A.<sup>15</sup> This exemption provides that amounts "paid" within 2-½ months after the later of the end of the employee's or employer's taxable year in which the employee's right to the amounts is no longer subject to a substantial risk of forfeiture does not constitute "deferred compensation" subject to Section 409A.<sup>16</sup> "Paid" for this purpose means that the amounts are treated as actually or constructively received.<sup>17</sup> For example, if a university President's employment contract provides that his right to certain deferred amounts will vest at the end of the contract term, and further provides that such deferred amounts must be distributed within 2-½ months after the end of the year in which the contract ends, the deferred amounts will not be subject to Section 409A. However, if the President's contract had a "rolling risk of forfeiture" provision permitting the President to extend the vesting and payment date, and the President had exercised this right, Section 409A would apply.<sup>18</sup> This is because a rolling risk of forfeiture is not a "substantial risk of forfeiture" for purposes of Section 409A.

### **Application of Section 409A to Section 457(f) Plans**

The requirements of Section 457(f) as well as the requirements of Section 409A apply to certain non-qualified deferred compensation plans of tax-exempt or governmental employers. Even if an arrangement complies with Section 409A, Section 457(f) may require that amounts deferred under the arrangement be included in taxable income before they are received.<sup>19</sup> Amounts subject to Section 457(f) generally must be included in taxable income as soon as they are no longer subject to a substantial risk of forfeiture. For purposes of Section 457(f), a substantial risk of forfeiture generally exists if the employee's right to the amount is conditioned on the employee's future performance of substantial services or some other future event. Although the term "substantial risk of forfeiture" is used for purposes of Section 457(f) as well as Section 409A, the meaning of this term is not the same for both Sections. However, the IRS has released guidance that it intends to issue prospective regulations defining substantial risk of forfeiture to have the same or similar meaning as under Section 409A.<sup>20</sup>

### **Requirements Relating to Employee Elections**

Although employee elections are not necessary for a non-qualified deferred compensation plan to exist, many non-qualified deferred compensation plans allow employees to elect the deferral amount as well as the time and form in which deferred amounts will be distributed. Code Section 409A strictly limits the timing of deferral elections and the circumstances under which elections may be changed.

In general, an employee's election to defer compensation for services performed during a calendar year must be made before the beginning of that year.<sup>21</sup> Thus, an election to defer compensation for services performed in 2008 must generally be made by December 31, 2007. A special rule applies to the first year in which a service provider becomes eligible to participate in a plan. In this situation, the service provider may make a deferral election with respect to compensation for services to be performed after the election at any time within 30 days after becoming eligible to participate.<sup>22</sup> Thus, if an employee first becomes eligible to defer compensation on July 1, 2008, he or she may make a deferral election at any time on or before July 30, 2008, with respect to compensation for services to be performed after that date.

Another special election rule applies to performance-based compensation for services performed over a period of at least 12 months. In this situation, the service provider may make a deferral election at any time at least six months before the end of the performance period.<sup>23</sup> For example, if a plan provides administrators a bonus based on calendar year performance, an administrator may elect to defer his or her bonus for 2008 performance at any time before July 1, 2008. The final regulations describe "performance-based compensation" as compensation (i) where payment or the amount of the compensation is contingent on the satisfaction of pre-established organizational or individual performance criteria relating to a performance period of at least 12 months, and (ii) the performance criteria are not substantially certain to be met when the deferral election is made.<sup>24</sup>

If a plan gives an employee the right to determine the timing and/or form in which deferred amounts will be paid, the employee must make that election at the time of his or her deferral election. Once an election is made, the employee's ability to change it is strictly limited. Applicable restrictions include the following:

- The employee generally may not accelerate the timing of the payment,<sup>25</sup>
- Any election to defer the elected distributions must be made at least 12 months before the effective date of the change,
- The plan must require that any election related to a payment to be made at a specified time must be made at least 12 months before the date of the first scheduled payment, and
- Any election to defer elected distributions for a reason other than death, disability, or an unforeseeable emergency must defer previously elected payments for a period of at least five years.<sup>26</sup>

The election requirements of Section 409A make "rolling risks of forfeiture" much less workable. For example, if a coach's contract provides that the coach will receive deferred compensation that vests and is payable at the end of a three year contract, but the contract provides that it is automatically extended another two years unless either party provides at least six months notice of termination, Section 409A's election rules will be violated. For a rolling risk of forfeiture to work after Section 409A, any delay in the vesting date would have to satisfy the Section 409A election change rules. In most cases, this would mean that the election would have to be made at least 12 months before the original vesting date, and the vesting/distribution date would have to be deferred for at least five years.

## **Annualized Salary Arrangements**

If an employer pays employees (either as general policy or as elected by the employee) salaries over a period longer than the period that the employee actually works (*e.g.* pay salary over twelve months for a faculty member who works ten months), then the final 409A regulations provide that this arrangement is subject to Section 409A.<sup>27</sup> There is a special election rule that applies to these annualized pay arrangements.

Generally, beginning in 2008, an election must be made in writing prior to the beginning of the work period (*e.g.* the academic year), be irrevocable for that work period, and state how salary is going to be paid. Additionally, the employer must state in writing the deadlines for making an election and the default schedule if no election is made.

## **Prohibition of Acceleration**

In general, Section 409A prohibits the acceleration of distributions, whether employer-initiated or employee-initiated.<sup>28</sup> Many existing non-qualified deferred compensation plans give the employer the right to terminate the plan at any time and distribute all deferred amounts in a lump sum on termination. This type of provision will be an impermissible acceleration unless it is limited to specific types of terminations set forth in the final regulations.

The final regulations list permitted accelerations under Section 409A. These include (i) distributions required by domestic relations orders, (ii) distributions required by federal conflict of interest rules, (iii) distributions to pay taxes on amounts deferred under a Section 457(f) plan, (iv) certain *de minimis* distributions, (v) distributions to pay required employment taxes on deferred amounts, (vi) cancellation of deferrals following an unforeseeable emergency or due to a disability, and (vii) certain specified types of plan terminations.<sup>29</sup>

## **Events of Distribution**

Under Section 409A, non-qualified deferred compensation may be distributed only upon:

- separation from service,
- death,
- a specified time (such as age 65) or pursuant to a fixed schedule,
- a change in control,<sup>30</sup>
- the occurrence of an unforeseen emergency,<sup>31</sup> or
- the service provider's disability.<sup>32</sup>

The termination of a plan is generally not a permissible distributable event. The events triggering the distribution of deferred amounts must be specified in the plan document or, if so provided by the plan document, elected by the employee during the election period for making deferrals.

## **Prohibited Funding Arrangements**

Section 409A prohibits the use of foreign trusts to fund non-qualified deferred compensation arrangements.<sup>33</sup> It also prohibits any plan provision that provides for the funding of plan obligations based on the employer's financial health.<sup>34</sup>

## **What is Needed to Comply With Section 409A**

Section 409A applies to the provisions of the written plan document as well as to the plan's operation. In other words, a perfectly written plan document will not protect the taxpayer, if the parties do not administer the plan in accordance with the document. Conversely, administering the plan in accordance with Section 409A will not protect the taxpayer, if the plan document contains provisions prohibited by Section 409A. It is essential that the written plan document, all election and other administrative forms, and the operation of the plan comply in all respects with Section 409A.

The final regulations, as modified by Notice 2007-86, require every plan subject to Section 409A to be (i) operated in a good faith compliance with Section 409A and the transition guidance from 2005 through 2008, and (ii) amended by the end of 2008 to comply with Section 409A.<sup>35</sup> They also allow employers and employees to make certain adjustments in 2008 that would otherwise be prohibited by Section 409A. For example, a plan may permit an employee to make new payment elections for previously deferred amounts, as long as a plan amendment permitting the election and the election are made by the end of 2008.<sup>36</sup>

## **Reporting Requirements**

All deferrals under a non-qualified deferred compensation plan must be reported annually, regardless of whether deferred amounts are vested or includible in gross income under Section 409A.<sup>37</sup> This reporting has been suspended for the years 2005, 2006 and 2007. The IRS has indicated that additional guidance will be issued providing a method for calculating the amount of deferrals made in a year. Non-compliance with the reporting requirements will not trigger the Section 409A tax and penalties on deferred amounts, but the usual penalties for incorrect reporting will apply.

## **Conclusion**

Section 409A significantly impacts the administration of non-qualified deferred compensation plans and imposes severe penalties for non-compliance. Colleges and universities should take advantage of the transition relief offered through the end of 2008 to identify the compensation arrangements that need to be amended and take steps to bring those plans in compliance with the new law.

This publication is intended for general purposes only and does not and is not intended to constitute legal advice. The reader must consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances.

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- <sup>1</sup> Section 885, Pub. Law No. 108-357, 118 Stat. 1418.
- <sup>2</sup> Code Section 409A(a)(2)-(4), (b).
- <sup>3</sup> Code Section 409A(a)(1)(B); Notice 2005-1, Q&A 2. See Notices 2006-100 and 2007-100 for transition rules applicable to the reporting and withholding requirements.
- <sup>4</sup> Treas. Reg. §1.409A-6(a).
- <sup>5</sup> Treas. Reg. §1.409A-6(a)(4).
- <sup>6</sup> Id.
- <sup>7</sup> Id.
- <sup>8</sup> Notice 2007-86.
- <sup>9</sup> Code Section 409A(1)(A)(i).
- <sup>10</sup> Treas. Reg. §1.409A-1(c)(1).
- <sup>11</sup> Treas. Reg. §1.409A-1(c)(2).
- <sup>12</sup> Code Section 409A(d)(1); Treas. Reg. §1.409A-1(a)(2) and (5).
- <sup>13</sup> Code Section 409A(d)(2), Treas. Reg. §1.409A-1(a)(2).
- <sup>14</sup> Treas. Reg. §1.409A-1(b)(1).
- <sup>15</sup> Treas. Reg. §1.409A-1(b)(4).
- <sup>16</sup> Treas. Reg. §1.409A-1(b)(4)(i)(A).
- <sup>17</sup> Treas. Reg. §1.409A-1(b)(4)(i)(B).
- <sup>18</sup> Treas. Reg. §1.409A-1(d)(1).
- <sup>19</sup> Treas. Reg. §1.409A-1(a)(4).
- <sup>20</sup> Notice 2007-62.
- <sup>21</sup> Code Section 409A(a)(4)(B)(i).
- <sup>22</sup> Code Section 409A(a)(4)(B)(ii).
- <sup>23</sup> Code Section 409A(a)(4)(B)(iii).
- <sup>24</sup> Treas. Reg. §1.409A-1(e)(1).
- <sup>25</sup> Code Section 409A(a)(3).
- <sup>26</sup> Code Section 409A(a)(4)(C).
- <sup>27</sup> Treas. Reg. §409A-2(a)(14).
- <sup>28</sup> Code Section 409A(a)(3).
- <sup>29</sup> Treas. Reg. §1.409A-3(j)(4).
- <sup>30</sup> The IRS indicated in the preamble to the final regulations that, until further guidance is issued, a tax-exempt entity may apply the change in effective control provisions of Treas. Reg. §1.409A-3(i)(5) (relating to a change in the composition of the board of directors) by analogy to changes in the composition of its board of directors, trustees, or other governing body.
- <sup>31</sup> "Unforeseen emergency" is defined similarly to the definition under Section 457(b). *See* Code Section 409A(a)(2)(B)(ii).
- <sup>32</sup> The definition of "disability" for purposes of Section 409A is similar to the Social Security definition. *See* Code Section 409A(a)(2)(C).
- <sup>33</sup> Code Section 409A(b)(1).
- <sup>34</sup> Code Section 409A(b)(2).
- <sup>35</sup> Notice 2007-86.
- <sup>36</sup> Id.
- <sup>37</sup> Notice 2005-1, Q&A 24.