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EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

LEGAL PERSPECTIVES

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409A Guidance Delayed

The "second round" of 409A guidance has been delayed until August or possibly September 2005. Treasury had originally said to expect this guidance in late Spring or early Summer. In light of the delay, we understand that Treasury is also considering extending the deadline for amending plans to comply with 409A until 2006 or later.

What is 409A Again?

As most of you know by now, last October, the American Jobs Creation Act of 2004 enacted the most sweeping changes in the law governing nonqualified deferred compensation plans in decades. See our client alert "Sweeping Changes to Law Governing Nonqualified Deferred Compensation Plans," October 2004, by **CLICKING HERE** or going to **http://www.chadbourne.com/memo/DeferredCompensationOct2004.pdf**. The new law was codified in a new Section 409A of the Internal Revenue Code. In December 2004, Treasury and IRS issued the "first round" of 409A guidance, providing much welcomed transitional relief for companies. See our client alert "Treasury and IRS Issue Key Guidance on New Nonqualified Deferred Compensation Law," December 2004, by **CLICKING HERE** or going to **http://www.chadbourne.com/memo/Dec2004-TreasuryandIRSIssueKeyGuidanceonNewNonq..pdf**. The transitional relief made clear that, although companies must generally operate their nonqualified deferred compensation plans in good faith compliance with 409A beginning January 1, 2005, companies have until December 31, 2005 to formally amend their plans to comply with 409A.

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Why Has it Taken So Long for Treasury and IRS to Issue More 409A Guidance?

The first round of guidance focused mainly on transitional relief and did not address many questions related to 409A. Treasury and IRS recognized this and requested comments and suggestions from the public. Over the past six months, Treasury and IRS have received hundreds of comment letters from companies, law firms, bar associations and industry groups suggesting ways to clarify and */ continued page 2*

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interpret 409A. Many of the comment letters presented issues and proposed solutions related to 409A's impact on international plans and employees, equity based plans (especially plans of privately held companies), supplemental executive retirement plans ("SERPs") and supplemental 401(k) plans ("401(k) wrap plans"), severance arrangements and employment agreements and hedge funds. As a result of the volume of comments received, it has taken Treasury and IRS longer than expected to issue the second round of guidance.

- coordination of qualified and nonqualified plans (in particular issues related to SERPs and 401(k) wrap plans);
- definitions necessary to operate and amend plans;
- deferral elections;
- distributions; and
- funding.

Treasury representatives cautioned that the second round of guidance will not address issues related to penalties. Guidance

> When asked whether Treasury believes summer ends on September 21, 2005 or Labor Day, one Treasury representative responded that he hopes summer ends sooner rather than later this year and that "August is as good a guess as any."

related to penalties and certain other 409A issues will likely be issued much later in 2005 or sometime in 2006.

When Will the Second Round of 409A Guidance Be Issued?

Treasury and IRS representatives have said to expect guidance "later this summer." When asked whether Treasury believes summer ends on September 21, 2005 (as our calendar would have us believe) or Labor Day (as most of us believe), one Treasury representative responded that he hopes summer ends sooner rather than later this year and that "August is as good a guess as any."

What Will the Second Round of 409A Guidance Cover?

Although Treasury and IRS representatives have not committed to a firm date (or even month) to issue the second round of 409A guidance, one Treasury representative promised that the new guidance will be a "high impact document" providing "substantial guidance." He noted that the new guidance will answer questions people need answers to in order to draft plan amendments. The second round of guidance is expected to address issues related to:

- international plans and employees;
- equity-based plans;
- severance arrangements;
- employment agreements;
- plan terminations;

Will the Deadline for 409A Plan Amendments Be Delayed?

Treasury representatives would not comment officially on whether Treasury and IRS will delay the December 31, 2005 deadline for amending nonqualified deferred compensation plans to comply with 409A. However, Treasury representatives have said that they understand the concern companies have with the tight deadline in adopting amendments to comply with 409A. Treasury representatives acknowledge that such amendments require sufficient lead time for plan design and coordination, consultation with experts, board approval, shareholder approval and, perhaps most importantly, communication to employees. Others have conceded informally that the later the second round of 409A guidance is issued, the more likely it is that additional time will be granted to bring plans into compliance with 409A. Any decision to extend the deadline will be made by high-ranking Treasury and IRS officials. We note that Treasury has received many public comments requesting that the amendment deadline be extended to the end of 2006 or even 180 days after final 409A regulations are issued. Any delay in the deadline, however, is not likely to extend the January 1, 2005 deadline for operating plans in good faith compliance with 409A.

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When Should Plans be Amended to Comply With 409A?

Treasury has advised companies to wait to amend plan documents until after the second round of guidance has been issued. Companies that amend plans before this guidance is issued run the risk of having to "undo" 409A amendments, duplicating time and expense or, worse, inadvertently causing plans to lose favorable grandfathered treatment.

Does My Company Need to Worry About a 409A Audit?

In a recent ALI-ABA conference, representatives of the IRS' business audit division were asked whether the IRS will be auditing plans for 409A compliance. One representative noted that it would begin 409A audits in earnest in 2007. To the collective dismay of those attending the conference, the same representative made it clear that the IRS would not refrain from raising 409A issues if it encountered them before 2007. This prompted the conference moderator to assure the IRS representative that "we have arranged for security to escort you from the building."

What Should My Company Be Doing Until the Second Round of Guidance is Issued?

Until the second round of 409A guidance is issued, companies are urged to take steps to ensure that their nonqualified deferred compensation plans and arrangements have been identified and reviewed. Although the deadline for amending plans to comply with 409A may be extended, nonqualified deferred compensation plans subject to 409A must operate in good faith compliance with 409A and the first round of guidance now. If you need help in identifying or reviewing your company's arrangements to ensure good faith compliance with 409A, we would be happy to help. ◎

IRS Relaxes FSA "Use It or Lose It" Rule

After years of pressure from Congress and industry groups, the IRS has relaxed the "use it or lose it" rule for health care and dependent care flexible spending arrangements ("FSAs"). Under the relaxed rule, companies may now give employees a grace period of up to 2½ months after the end of the plan year to use any FSA account balances remaining at plan year end.

This is good news for many employees who find it difficult to estimate how much money to set aside to pay FSA expenses during the plan year. Under the old rule, employees who estimated incorrectly would automatically lose any unused FSA account balances at plan year-end (December 31st for most plans). To avoid this result, many employees make a mad dash to the dentist or eye doctor in December to incur last minute reimbursable FSA expenses. The relaxed rule gives employees some extra time to incur reimbursable expenses to offset year-end FSA account balances.

The 2½-month grace period is optional. This means that companies may choose to offer the grace period or choose to retain the old "use it or lose it" rule. The grace period would be a welcome change for employees, but would complicate FSA administration (at least initially). Some of the administrative issues to consider include:

- **"Run-Off" Period.** FSAs typically offer a 60 to 90 day "run-off" period following the end of the plan year in which employees may submit final claims for the plan year. If a grace period is added, companies may wish to consider extending the run-off period to a 60 or 90 day period following the end of the grace period. If the "run-off" period is extended, final claims information may not be available in time to complete the FSA's Form 5500 by its due date (July 31st for a calendar year plan) and it may be necessary to file an extension to file the FSA's Form 5500.
- **Coordinating Grace Period Claims.** Companies will need to determine how to coordinate claims incurred during the grace period among the FSA's old plan year and the new plan year. For example, if a company adds a 2½-month grace period to its FSA for the 2005 plan year,

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IRS Relaxes FSA "Use It or Lose It" Rule

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the company would need to consider whether FSA eligible claims incurred from January 1 through March 15, 2006 would be used to offset 2005 FSA balances or 2006 FSA balances. (For obvious reasons, most companies would typically choose to offset old plan year claims first.)

- **Effect on HSA Plans.** Companies switching from an FSA to a Health Savings Account plan ("HSA") should proceed cautiously before adding a grace period to the terminating FSA. The law restricts companies from maintaining HSAs and FSAs during the same period, except in certain cases. As a result, adding a grace period to the end of a terminating FSA could adversely affect a company's HSA.

Companies wishing to take advantage of the new grace period must do the following:

- Formally amend their plan documents to provide for the grace period (companies wishing to amend their FSAs to provide a grace period for 2005 must formally amend their plans by December 31, 2005);
- Update FSA summaries, employee communications and administrative forms to reflect the grace period;
- Apply the grace period to all plan participants; and
- Ensure that the grace period ends no later than the 15th day of the third calendar month after the end of the FSA's plan year (March 15th for calendar year plans).

Finally, it is important to remember that although the new rule allows a 2½-month grace period, the new rule does not eliminate or otherwise change the "use it or lose it" rule. FSAs still cannot permit unused amounts to be cashed-out or converted to another form of benefit. For example, amounts contributed to a health care reimbursement account may not be used to pay dependent care expenses.

For more information about the new grace period or how it affects your company's FSA (or HSA), please give us a call. As many FSAs do not always get the attention they deserve, now would also be a good time to review FSA plan documents, summaries and employee communications to make sure the documents are up-to-date.

New Bankruptcy Law: How it Affects Your Company's Employee Benefits And Executive Compensation

The new bankruptcy law affects your company's employee benefit plans. The new law generally protects your company's employees who have filed for bankruptcy by making clear that tax-qualified retirement plans and individual retirement accounts and annuities ("IRAs") are off-limits to creditors and by protecting plan loan repayments and wage withholding. If your company is in bankruptcy, the new law imposes strict new restrictions on your company's employee benefit plans and executive compensation arrangements.

The new law, called the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, applies generally to bankruptcy filings on or after October 17, 2005.

How the New Law Affects Your Company's Employee Benefit Plans

Protects Company Employee Benefit Plans from Creditors' Claims

Exempt Arrangements. The new law makes clear that assets of the following employee benefit arrangements are not subject to claims of creditors in the event a company employee is in bankruptcy:

- Traditional pension plans, profit-sharing plans, ESOPs and 401(k) plans qualified under Internal Revenue Code Section 401(a) (also called "tax-qualified plans");

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- Tax-deferred annuity plans (also called "403(b) plans");
- Governmental and church plans;
- Tax-exempt and state and local government plans (also called "457 plans"); and
- IRAs (up to certain limits).

Before the new law was enacted, the Supreme Court decision of *Patterson v. Shumate* and subsequent case law exempted tax-qualified plans and certain other arrangements subject to ERISA, but left open the question of whether other arrangements were exempt from an employee's bankruptcy estate. The new law puts to rest many questions left unanswered by case law.

Requirements for Exempt Arrangements. The new law makes clear that, for assets of these employee benefit arrangements to be exempt, the following requirements must be met:

- The arrangement must have a favorable determination letter or it must be demonstrated that the arrangement is in substantial compliance with the Internal Revenue Code;
- The IRS or a court must not have determined that the arrangement is not in compliance with the law;
- If an arrangement is not in substantial compliance with the Internal Revenue Code, the arrangement may still be considered exempt for bankruptcy purposes if the employee is not materially responsible for the arrangement's non-compliance.

As a practical matter, the only plans that will have a favorable determination letter from the IRS are tax-qualified plans. This means that other arrangements, such as 403(b) plans, 457 plans and IRAs, must instead demonstrate that they are in substantial compliance with the Internal Revenue Code and/or otherwise meet the requirements noted above.

The new law does not make clear whether a prototype plan opinion letter qualifies as a favorable determination letter. Many tax-qualified plans — especially 401(k) plans — rely on prototype plan opinion letters. It is hoped that this open issue will be resolved in the future.

Limits for IRAs. The new law exempts from a bankrupt employee's estate up to $1 million held in an IRA. The $1 million cap applies to Roth IRAs, but does not apply to Simplified Employee Pension Plans ("SEPs") or SIMPLE IRAs. The $1 million cap also does not apply to amounts rolled over from tax-qualified, 403(b) or 457 plans. The new law gives courts the authority to increase the $1 million cap "if the interests of justice so require".

This change in the law may encourage former employees, who may have chosen to leave their plan account balances with your company to protect their account balances from creditors, to now consider rolling their company plan account balances to an IRA.

Other Provisions Affecting Your Company's Employee Benefit Plans

Plan Loans. The new law allows plans to continue to deduct plan loan repayments from a bankrupt employee's wages. Before the new law was enacted, the law generally prohibited deductions from a bankrupt employee's paycheck to repay a plan loan.

Wage Withholding. The new law provides that any amount your company withholds from a bankrupt employee's wages or receives from a bankrupt employee for contributions to your company's employee benefit plans are exempt from the employee's bankruptcy estate. This protects 401(k) plan contributions, health insurance premiums and other amounts that were withheld but not yet contributed to your company's employee benefit plans.

How Does the New Law Affect Companies In Bankruptcy?

Increased Priority for Unpaid Plan Contributions

The new law increases the dollar limit on priority claims for unpaid plan contributions to $10,000 (from $4,925) per plan participant for companies that are in bankruptcy. (The dollar limit may be reduced for certain other priority claims related to other employee contributions.) This means that if your company should ever have to file for bankruptcy, claims for unpaid plan contributions of up to $10,000 per participant will generally have priority over other unsecured claims.

Retiree Medical Plans

The new law provides that a court may */ continued page 6*

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unwind any modification (or reinstate any benefit reduction) that your company may have made to its retiree medical plans during the 180-day period before the bankruptcy filing, if the court determines that your company was insolvent at the time the modification was made. However, a court may refuse to do so if the "balance of equities" favors the modification that your company made. This change makes it easier for a court to revisit and undo otherwise lawful and negotiated revisions to your company's retiree medical plan.

Executive Retention and Severance Payments

The new law imposes strict limits on retention bonuses and severance payments to executives of companies that are in bankruptcy. These new strict limits are likely to make it more difficult for companies to retain their key management personnel during the bankruptcy proceeding.

Retention payments made to company insiders (generally, officers and other key employees) will only be permitted if a court finds that:

- the payment is essential to retain the insider because he or she has a competing job offer that provides the same or greater compensation;
- the individual provides services that are essential to the company's survival; and
- the amount of the payment is no greater than 10 times the amount of the average retention bonus given to non-management employees during the prior calendar year or, if no such bonuses were given, no greater than 25% of the amount of similar payments or obligations made to the insider for any reason during the prior calendar year.

Severance payments made to company insiders will only be permitted if a court finds that:

- the payment is part of a program that applies generally to all of the company's full-time employees; and
- the amount of the payment is no greater than 10 times the amount of the average severance payment made to non-management employees during the same calendar year.

For more information regarding how the new bankruptcy law affects your company's employee benefit plans, please call us.

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