# 106 Hot Topics in Employee Benefits Law

**Jim F. Merna**
*Attorney*
United Parcel Service of America, Inc.

**Jeffrey A. Monhart**
*Chief Division of Field Operations*
United States Department of Labor

**Leslie Reicin Stein**
*Senior Vice President & General Counsel*
Special Data Processing Corporation

# Faculty Biographies

**Jim F. Merna**

Jim Merna is an attorney for United Parcel Service, Inc. in Atlanta. His responsibilities include providing legal counsel for the operation of several qualified retirement plans, including defined benefit plans, defined contribution plans, and multi-employer pension plans.

Prior to joining UPS, Mr. Merna served as in-house benefits counsel at Delta Air Lines, Inc. and was an associate at King & Spalding.

Mr. Merna received a B.S. from the U.S. Naval Academy and graduated cum laude from the Georgia State University College of Law.

**Jeffrey A. Monhart**

Jeffrey A. Monhart is the chief, division of field operations in the Office of Enforcement, Employee Benefits Security Administration. His division provides oversight and guidance to EBSA's 15 field offices, which conduct investigations of private-sector employee pension and welfare benefit plans. Since joining the Department of Labor in 1993, he has overseen such projects as the Voluntary Fiduciary Correction Program and the Employee Contributions Project.

Mr. Monhart is a graduate of Colby College and he received his J.D. from the University of Montana School of Law.

**Leslie Reicin Stein**

Leslie Reicin Stein is senior vice president and general counsel for Special Data Processing Corporation (SDP) in Clearwater, Florida. Her responsibilities include management of the legal, human resources and compliance departments. During the past year she has been responsible, as both the lawyer and the head of human resources, for the restructuring of employee benefits for a diverse workforce. Ms. Stein is an adjunct professor at Stetson University College of Law, where she specializes in the teaching of labor and employment discrimination classes.

Prior to joining SDP, Ms. Stein was an in-house counsel for GTE/Verizon, serving most recently as general counsel, director and corporate secretary of several Verizon technology subsidiaries including Verizon Data Services, Inc., Verizon Information Technologies, Inc., and various companies in India, Mexico, Venezuela, and Germany. Her prior experience includes positions as associate general counsel commercial and labor at GTE Telephone Operations (South Area) and chief labor counsel at GTE Florida, Inc.

Ms. Stein currently serves on the Florida Bar editorial board, the Hillsborough County Bar Foundation board, the board of overseers of Stetson University College of Law, and the Davis Island Civic Association board. She is president of the Dana Foundation and a member of the labor and employment law executive council of The Florida Bar. She is former president of the Florida Association for Women Lawyers, vice chair of the National Conference of Women's Bar Associations, chair of the Florida and Hillsborough County Corporate Counsel Committees, chair of the Central Florida Industrial Relations Research board, chair of the City of Tampa Civil Service board, and national vice chair for the National Conference for Community & Justice.

Ms. Stein holds an an A.B. from the University of Michigan, J.D. from Stetson University College of Law, a M.B.A. from the University of Tampa, and a M.A. from the University of South Florida. She is a member of Phi Beta Kappa, Phi Kappa Phi, Phi Alpha Theta, and was editor in chief of the Stetson University Law Review.

The new tax rules for nonqualified deferred compensation plans ("NQDC Plans") became effective January 1, 2005. The IRS issued its initial guidance on the new law (IRS Notice 2005-1) in late December. That lengthy guidance (36 pages) covered several (but not all) aspects of the new rules. It is anticipated that the next set of guidance will address issues related to distributions and deferral elections and may be released in August or September. Additionally, the IRS has indicated that it expects to begin auditing the 2005 transition year sometime in 2007 and focus in areas where the law and guidance are clear.

The following Detailed Summary is designed to give you a summary of the key provisions of these new rules.

1. **Definition of NQDC Plan.** The definition of NQDC Plan is broad enough to capture many types of arrangements.

- The definition does not require an affirmative deferral election by the service provider.
  - For example, the rules apply to traditional salary deferral arrangements as well as supplemental executive retirement plans.
- The definition does not require the service provider to have an immediate right to compensation in the year that services are performed.
  - For example, the definition does not require that the compensation be made available to the service provider when the services are performed as in a salary reduction arrangement.
- Compensation promised under a NQDC Plan may be subject to forfeiture conditions.
  - For example, the right to compensation in a future year may be subject to forfeiture as a result of employment termination or failure to satisfy performance goals.
- The definition does not include arrangements under which a service recipient has a unilateral right to reduce or eliminate the compensation after the services have been performed.
  - For example, if the service recipient may reduce the amount of compensation at any time and for any reason, there is no "legally binding right" to compensation.

2. **Not NQDC Plans.** The following are not treated as nonqualified deferred compensation or NQDC Plans:

- Qualified plans.
- Short-term deferrals paid within 2½ months after the end of the year in which the amounts become vested.
  - This exception will apply to many bonus and other plans that make payment soon after the service provider is vested.
  - However, if the bonus or other payment may be deferred, the plan under which the deferral is permitted may be a NQDC Plan.
  - Note this exception may change in future guidance.
- Stock option plans that grant fair market value options.
  - This exception includes both incentive and non-incentive options with no deferral features.
  - Options granted in substitution of fair market value options in connection with a business transaction are not treated as nonqualified deferred compensation if the substitution complies with requirements applicable to incentive stock options.
  - This exception also is applicable to options to acquire partnership interests, for now.
- Employee stock purchase plans that satisfy Internal Revenue Code requirements.
  - Note that employee stock purchase plans that do not satisfy Internal Revenue Code requirements, for example, because they were not approved by shareholders, may nevertheless be exempt if there is no discount on the purchase price.
- Restricted stock and other transfers of property.
  - This exception also is applicable to the issuance of partnership interests (capital or profits), for now.
  - However, promises to transfer property in the future, for example restricted stock units, are not excepted and are covered under the new rules.
  - Also, a deferral of cash dividends on restricted stock may present an issue if the short-term deferral rule is not retained in final guidance.
- Stock appreciation rights ("SARs").
  - SARs settled in publicly traded stock are not nonqualified deferred compensation if the exercise price is at least equal to the fair market value of the stock at grant and there are no other deferral features.
  - SARs issued under a plan in effect on October 3, 2004 settled in cash or stock that is not publicly traded are not nonqualified deferred compensation if the exercise price is at least equal to the fair market value of the stock at grant and there are no other deferral features.
- Payments of partnership distributive shares or guaranteed payments, taxable under Section 736 of the Internal Revenue Code.
  - But partnership payments that are treated as retirement income for self-employment tax purposes are subject to the new rules.
- Bona fide vacation leave, sick leave compensatory time, disability pay or death benefit plans.
- Health or medical savings accounts and certain medical reimbursement arrangements.
  - Note that discriminatory medical coverage for former executives may not be exempt unless it is insured coverage.

3. **Timing of deferral elections**.

- Elections to defer compensation must be made before the beginning of the calendar year in which the services will be performed (not when the compensation will be paid). For example, if a bonus for 2006 is payable in 2007, an election to defer the bonus will need to be made in 2005.
- If the bonus is "performance-based" and the performance period is at least 12 months, the deferral election may be postponed until 6 months before the end of the performance period. For example, if the bonus for 2006 is based on achieving performance goals, the election may be made as late as June 30, 2006 as long as the achievement of the goals is uncertain on that date.
  - The guidance is fairly lenient on what constitutes a "performance-based" bonus – the bonus must be contingent on satisfaction of organizational or individual performance criteria and it is not substantially certain that the goals will be satisfied at the time of the election.
  - Special rules apply when the performance goals are subjective.

Special Rules for 2005

- Service providers may be permitted to terminate participation altogether or reduce their deferral elections for 2005 provided the amounts subject to these elections are treated as income in 2005 or, if later, when vested. The right to terminate participation does not have to be provided uniformly to all employees.
- Service providers have a one-time exception to the rule that deferral elections must be made in the calendar year before the service is performed. Service providers may make a new deferral election for future pay on or before March 15, 2005; provided,
  - a written NQDC Plan was in effect by December 31, 2004;
  - the NQDC Plan provided for deferral of the type of compensation elected to be deferred; and
  - the NQDC Plan is amended by December 31, 2005 to conform to the election.

Note this election will be very important for deferral of bonuses under non-performance-based bonus programs in which the bonus is earned in 2005 but paid in a later year. This election also will be important for nonqualified 401(k) supplemental plans which base deferrals on elections made under the qualified 401(k) plan, i.e., there are no separate deferral elections under the nonqualified plan. Clients with either of these arrangements should take action on or before March 15.

4. **Timing of distributions**. Distribution may be made only on the following distribution events:

- Separation from service. Separation from service is not yet defined. Many may remember this term from 401(k) plans, when it was interpreted very restrictively.
  - "Key employees" of a publicly traded corporation must wait at least 6 months following a separation from service.
  - Key employees include:
    - Top 50 highest paid officers of the corporation or any subsidiary with annual compensation in excess of $130,000 (adjusted for cost of living);
    - Any 1% owner with annual compensation of more than $150,000; and
    - Any 5% owner.
- Disability. Disability is defined as a condition that is expected to result in death or to last for at least 12 months and either causes the service provider to be unable to engage in any substantial gainful activity or to receive income replacement benefits for at least 3 months under a service recipient's accident and health plan.
- Death.
- Specified time or fixed schedule.
  - The payment is made on a fixed date or series of dates, for example, at age 55 or on each anniversary of a particular date.
  - Note that the occurrence of an event such as a child entering college will not be treated as a specified time or fixed schedule.
- Change in control. (See Section 5, below.)
- Unforeseeable emergency. Unforeseeable emergency is limited to severe financial hardship resulting from an illness or accident of the service provider, the service provider's spouse or a dependent; loss of property due to casualty or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider.
- Vesting. These distribution events are limitations on distribution, not vesting. Thus, a NQDC Plan may provide for vesting on other events, for example, upon a change in control that is different from the definition below.

  Special Rules for 2005

- Service providers may change the time or form of payment for any amounts subject to the new rules on or before December 31, 2005.
  - Note that service providers may retain any right in existence on October 3, 2004 to make changes to "grandfathered amounts."
  - For 2005, it will be permissible to continue to tie the form and timing of payment to qualified plan payments (to the extent tied to a qualified plan as of October 3, 2004).

5. **Change in Control Provisions**.

- A "change in control event" is a distribution event if the change in control is:
  - A change in the ownership of a corporation, which is the attainment of ownership of more than 50% of the voting power or value of the corporation;
  - A change in the effective control of a corporation, which is the acquisition of more than 35% of the voting power or a change in the majority of board members within a 12-month period; or
  - A change in the ownership of a substantial portion of the assets of a corporation, which is a transfer to an "unrelated" person or group of more than 40% of the value of all assets within a 12-month period.
- The definitions do not allow for the exercise of discretion. Thus, a common provision that would allow the board of directors to declare that a transaction is not a change in control would not be acceptable if it affects the timing of payment under a NQDC Plan.
- The change in control distribution event does not apply to partnerships, limited liability companies, or sole proprietorships.

6. **Changes in the Form or Timing of Payments**.

- Where the service provider is given a choice of distribution options, the time and form of payment must be selected at the time of the initial deferral election.
  - The NQDC Plan could mandate the time and form of payment and is not required to allow the service provider to choose the time and form of payment.
- The time of payment may not be accelerated except under the following circumstances:
  - Payments required under a domestic relations order;
  - Payments required as a result of certain conflicts of interest;
  - Payments to cover income taxes imposed as a result of a vesting event or FICA taxes; or
  - Cashout of $10,000 or less.
- Note that nothing prohibits acceleration of vesting.
- Payment may be postponed and the form of payment changed; provided
  - The new election is made at least 12 months before the payment would otherwise be made and
  - The new payment date must be at least 5 years from the date the payment otherwise would have been made.
- In the case of fixed payments, the election must be made at least 12 months before the date of the first scheduled payment.

7. **Reporting.** Amounts deferred under a nonqualified deferred compensation arrangement now will have to be reported on an individual's Form W-2 (or Form 1099) for the year deferred, even if the amount is not includable in income for that taxable year. Amounts included in income as a result of a violation will be subject to withholding.

8. **Funding.** Setting aside assets to fund a nonqualified deferred compensation arrangement generally results in immediate income to the affected participants if (a) the assets are located offshore or (b) the assets are set aside in connection with a decline in the service recipient's financial health.

   Otherwise, rabbi trusts are allowed. Note the new law does not prohibit a requirement that the service recipient fully fund benefits in connection with a change in control.

9. **Grandfathered Amounts.** Certain amounts deferred before January 1, 2005 will not be subject to the new rules and may be paid in accordance with the terms of the NQDC Plan as in effect on October 3, 2004 as long as that plan is not "materially modified" after October 3, 2004.

- Grandfathering, if applicable, will apply on an individual basis.
  - If more than one service provider participates in a NQDC Plan, some service providers' benefits may be grandfathered and some may not.
  - Grandfathering may create administrative burdens.
  - For any individual, some compensation may be grandfathered and some may not.
- There are two requirements for grandfathering:

- The service provider must have a "legally binding right" to the compensation before January 1, 2005; and
- The service provider's right to the compensation must be "earned and vested" before January 1, 2005.

The phrase "earned and vested" means that the service provider's right to the compensation is not subject to a substantial risk of forfeiture and is not subject to a requirement that the service provider perform further services.

- The guidance makes clear that the amount of deferred compensation that is grandfathered will be fixed as of December 31, 2004.
  - If the compensation is defined in terms of an account balance, the grandfathered compensation will be the account balance as of December 31, 2004, as subsequently adjusted for investment gains or losses.
  - If the compensation is not defined in terms of an account balance, the grandfathered amount will be the present value (using reasonable actuarial assumptions) of the compensation that would be payable at the earliest payment date if the services provider's relationship with the service recipient had terminated on December 31, 2004.
  - Equity-based plans are treated as account balance plans and appreciation in the underlying stock is treated as part of the grandfathered amount.

**10. <u>Material Modification</u>.**

- A plan is "materially modified" if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added (even if the new benefit satisfies the new rules).
- The following are <u>not</u> treated as a material modification:
  - Certain changes in or the addition of certain investment options.
  - Exercise by a service provider of a right that existed under the plan as of October 3, 2004, for example, the right to change payment options.
  - Freezing the plan.
  - Terminating the plan on or before December 31, 2005 if amounts are treated as income in the year of the termination.
  - Cancellation and reissuance of SARs or options on or before December 31, 2005 if the number of shares corresponds to the original grant and there is no additional benefit conferred.

**11. <u>Plan Amendments</u>.**

- No immediate action is required.
- NQDC Plans will have until December 31, 2005 to make conforming amendments; provided the plan is operated in good faith compliance with the statute and guidance pending such amendment.

**Internal Revenue Code**

§ 409A Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans.

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**(a) Rules relating to constructive receipt.**

**(1) Plan failures.**

(A) Gross income inclusion.

(i) In general. If at any time during a taxable year a nonqualified deferred compensation plan—

(I) fails to meet the requirements of paragraphs (2) , (3) , and (4) , or

(II) is not operated in accordance with such requirements,

all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

(ii) Application only to affected participants. Clause (i) shall only apply with respect to all compensation deferred under the plan for participants with respect to whom the failure relates.

(B) Interest and additional tax payable with respect to previously deferred compensation.

(i) In general. If compensation is required to be included in gross income under subparagraph (A) for a taxable year, the tax imposed by this chapter for the taxable year shall be increased by the sum of—

(I) the amount of interest determined under clause (ii) , and

(II) an amount equal to 20 percent of the compensation which is required to be included in gross income.

(ii) Interest. For purposes of clause (i) , the interest determined under this clause for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

**(2) Distributions.**

(A) In general. The requirements of this paragraph are met if the plan provides that compensation deferred under the plan may not be distributed earlier than—

(i) separation from service as determined by the Secretary (except as provided in subparagraph (B)(i) ),

(ii) the date the participant becomes disabled (within the meaning of subparagraph (C) ),

(iii) death,

(iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation,

(v) to the extent provided by the Secretary, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or

(vi) the occurrence of an unforeseeable emergency.

(B) Special rules.

(i) Specified employees. In the case of any specified employee, the requirement of subparagraph (A)(i) is met only if distributions may not be made before the date which is 6 months after the date of separation from service (or, if earlier, the date of death of the employee). For purposes of the preceding sentence, a specified employee is a key employee (as defined in section 416(i) without regard to paragraph (5) thereof) of a corporation any stock in which is publicly traded on an established securities market or otherwise.

(ii) Unforeseeable emergency. For purposes of subparagraph (A)(vi) —

(I) In general. The term “unforeseeable emergency” means a severe financial hardship to the participant resulting from an illness or accident of the participant, the participant's spouse, or a dependent (as defined in section 152(a) ) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

(II) Limitation on distributions. The requirement of subparagraph (A)(vi) is met only if, as determined under regulations of the Secretary, the amounts distributed with respect to an emergency do not exceed the amounts necessary to satisfy such emergency plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such hardship is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the participant's assets (to the extent the liquidation of such assets would not itself cause severe financial hardship).

(C) Disabled. For purposes of subparagraph (A)(ii) , a participant shall be considered disabled if the participant—

(i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or

(ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

**(3) Acceleration of benefits.**
The requirements of this paragraph are met if the plan does not permit the acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary.

**(4) Elections.**

(A) In general. The requirements of this paragraph are met if the requirements of subparagraphs (B) and (C) are met.

(B) Initial deferral decision.

(i) In general. The requirements of this subparagraph are met if the plan provides that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer such compensation is made not later than the close of the preceding taxable year or at such other time as provided in regulations.

(ii) First year of eligibility. In the case of the first year in which a participant becomes eligible to participate in the plan, such election may be made with respect to services to be performed subsequent to the election within 30 days after the date the participant becomes eligible to participate in such plan.

(iii) Performance-based compensation. In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than 6 months before the end of the period.

(C) Changes in time and form of distribution. The requirements of this subparagraph are met if, in the case of a plan which permits under a subsequent election a delay in a payment or a change in the form of payment—

(i) the plan requires that such election may not take effect until at least 12 months after the date on which the election is made,

(ii) in the case of an election related to a payment not described in clause (ii) , (iii) , or (vi) of paragraph (2)(A), the plan requires that the first payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been made, and

(iii) the plan requires that any election related to a payment described in paragraph (2)(A)(iv) may not be made less than 12 months prior to the date of the first scheduled payment under such paragraph .

**(b) Rules relating to funding.**

**(1) Offshore property in a trust.**
In the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying deferred compensation under a nonqualified deferred compensation plan, for purposes of section 83 such assets shall be treated as property transferred in connection with the performance of services whether or not such assets are available to satisfy claims of general creditors—

(A) at the time set aside if such assets (or such trust or other arrangement) are located outside of the United States, or

(B) at the time transferred if such assets (or such trust or other arrangement) are subsequently transferred outside of the United States.

This paragraph shall not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such jurisdiction.

**(2) Employer's financial health.**
In the case of compensation deferred under a nonqualified deferred compensation plan, there is a transfer of property within the meaning of section 83 with respect to such compensation as of the earlier of—

(A) the date on which the plan first provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health, or

(B) the date on which assets are so restricted,

whether or not such assets are available to satisfy claims of general creditors.

**(3) Income inclusion for offshore trusts and employer's financial health.**
For each taxable year that assets treated as transferred under this subsection remain set aside in a trust or other arrangement subject to paragraph (1) or (2) , any increase in value in, or earnings with respect to, such assets shall be treated as an additional transfer of property under this subsection (to the extent not previously included in income).

**(4) Interest on tax liability payable with respect to transferred property.**

(A) In general. If amounts are required to be included in gross income by reason of paragraph (1) or (2) for a taxable year, the tax imposed by this chapter for such taxable year shall be increased by the sum of—

(i) the amount of interest determined under subparagraph (B) , and

(ii) an amount equal to 20 percent of the amounts required to be included in gross income.

(B) Interest. For purposes of subparagraph (A) , the interest determined under this subparagraph for any taxable year is the amount of interest at the underpayment rate plus 1 percentage point on the underpayments that would have occurred had the amounts so required to be included in gross income by paragraph (1) or (2) been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such amounts are not subject to a substantial risk of forfeiture.

**(c) No inference on earlier income inclusion or requirement of later inclusion.**
Nothing in this section shall be construed to prevent the inclusion of amounts in gross income under any other provision of this chapter or any other rule of law earlier than the time provided in this section . Any amount included in gross income under this section shall not be required to be included in gross income under any other provision of this chapter or any other rule of law later than the time provided in this section.

**(d) Other definitions and special rules.**
For purposes of this section —

**(1) Nonqualified deferred compensation plan.**
The term "nonqualified deferred compensation plan" means any plan that provides for the deferral of compensation, other than—

(A) a qualified employer plan, and

(B) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

**(2) Qualified employer plan.**
The term "qualified employer plan" means—

(A) any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of section 219(g)(5) (without regard to subparagraph (A)(iii)),

(B) any eligible deferred compensation plan (within the meaning of section 457(b) ), and

(C) any plan described in section 415(m) .

**(3) Plan includes arrangements, etc.**
The term “plan” includes any agreement or arrangement, including an agreement or arrangement that includes one person.

**(4) Substantial risk of forfeiture.**
The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

**(5) Treatment of earnings.**
References to deferred compensation shall be treated as including references to income (whether actual or notional) attributable to such compensation or such income.

**(6) Aggregation rules.**
Except as provided by the Secretary, rules similar to the rules of subsections (b) and (c) of section 414 shall apply.

**(e) Regulations.**
The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section , including regulations—

**(1)** providing for the determination of amounts of deferral in the case of a nonqualified deferred compensation plan which is a defined benefit plan,

**(2)** relating to changes in the ownership and control of a corporation or assets of a corporation for purposes of subsection (a)(2)(A)(v) ,

**(3)** exempting arrangements from the application of subsection (b) if such arrangements will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors,

**(4)** defining financial health for purposes of subsection (b)(2) , and

**(5)** disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of this section .

**Notices**

- Notice 2005-1, 2005-2 IRB 274, 12/20/2004, IRC Sec(s). 409A

Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans.

I. Purpose and Overview

Section 885 of the recently enacted American Jobs Creation Act of 2004, Pub. Law No. 108-357, 118 Stat. 1418 (the Act), added § 409A to the Internal Revenue Code (Code). Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

As explained more fully below, this notice provides the first part of what is expected to be a series of guidance with respect to the application of § 409A. The Treasury Department and the Internal Revenue Service (Service) intend to incorporate the principles of this notice into additional, more comprehensive guidance in 2005.

Taxpayers should note that although the statute makes a number of fundamental changes, § 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine. Accordingly, deferred compensation not required to be included in income under § 409A may nevertheless be required to be included in income under § 451, the constructive receipt doctrine, the cash equivalency doctrine, § 83, the economic benefit doctrine, the assignment of income doctrine or any other applicable provision of the Code or common law tax doctrine.

A. Definitions and Coverage

This notice generally outlines the scope of coverage of § 409A. The notice first provides definitions of a nonqualified deferred compensation plan, a plan and the deferral of compensation. Guidance is provided on the application of § 409A to welfare plans, plans covered by § 457, stock appreciation rights, and arrangements between partners and partnerships. This notice provides a definition of a substantial risk of forfeiture.

The definition of nonqualified deferred compensation contains an exception for amounts actually or constructively received by the service provider within a short period following the lapse of a substantial risk of forfeiture. The exception is intended to address multi-year compensation arrangements, where the right to the compensation is or may be earned over multiple years but is payable at the end of the earning period. For example, a three-year bonus program requiring the performance of services over three years and entitling the service provider to a payment within a short specified period following the end of the third year generally would not constitute a deferral of compensation. The Treasury Department and the Service are, however, concerned about arrangements purported to involve a substantial risk of forfeiture and fixed payment date where the parties do not intend for the substantial risk of forfeiture or fixed payment date to be enforced. Accordingly, the Treasury Department and the Service are considering a more restrictive rule under which arrangements involving payments in later taxable years structured to coincide with a lapse in a substantial risk of forfeiture would constitute deferrals of compensation subject to § 409A. However, even under a more restrictive rule, the Treasury Department and the Service anticipate that a payment within a short period following a scheduled vesting date and, in specified circumstances, within a short period following an accelerated vesting date, would be permitted under the statutory authority provided to permit accelerated payments that are not inconsistent with the purposes of the statute. Comments are requested with respect to these issues and the extent to which additional guidance is required to prevent arrangements designed to evade application of § 409A.

This notice does not provide generally applicable methods for calculating the amount of deferrals for a given year. However, a rule is provided for calculation of the amount of deferrals before January 1, 2005 for purposes of applying the effective date provisions. The Treasury Department and the Service anticipate issuing guidance in 2005 providing methods for calculating the amount of deferrals for purposes of all deferrals to which § 409A applies, including deferrals preceding the issuance of the guidance. Until such guidance is issued, certain transition relief is provided to address information reporting and withholding requirements. However, nothing in this guidance should be interpreted to exempt amounts actually distributed to the taxpayer in 2005 from inclusion in income or from applicable reporting or withholding requirements.

B. Nonstatutory Stock Options and Stock Appreciation Rights

The definition of nonqualified deferred compensation contains an exception that generally excludes certain nonstatutory stock options from coverage under § 409A. This exception is consistent with the further exception covering transfers of restricted property, as the taxation of transfers of nonstatutory stock options and transfers of restricted property generally both are governed by § 83. Commentators have pointed out that under certain conditions, stock appreciation rights yield economically equivalent results to nonstatutory stock options exercised in a cashless transaction, and have requested that stock appreciation rights be treated similarly. However, the Treasury Department and the Service are concerned that a general exception for stock appreciation rights may be exploited as a method to avoid application of § 409A, particularly in regard to valuation of the underlying stock where the value is not established by and in an established securities market. In many respects, stock appreciation rights are similar to other forms of nonqualified deferred compensation, particularly where the recipient of a stock appreciation right may receive cash. In such cases, the taxation of stock appreciation rights generally is governed by § 451 and the constructive receipt doctrine. See Rev. Rul. 80-300, 1982-2 C.B. 165.

Accordingly, this notice provides limited exceptions from coverage under § 409A for certain stock appreciation rights which do not present potential for abuse or intentional circumvention of the purposes of § 409A. Under this exception, a stock appreciation right will not constitute a deferral of compensation if (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock of the service recipient subject to the right is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement of the right upon exercise, and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. In addition, until further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such a right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. The Treasury Department and the Service request comments on the extent to which stock appreciation rights should be excepted from coverage under § 409A, in light of the statutory purpose.

The Treasury Department and the Service also are concerned about the potential for taxpayers to avoid application of § 409A by combining an exception from coverage under § 409A for nonstatutory stock options or stock appreciation rights with a requirement or right that the stock acquired by the service provider be repurchased by the service recipient. Accordingly, the Treasury Department and the Service are considering a restriction on the exception from coverage under § 409A for nonstatutory stock options or stock appreciation rights, to options or rights that are not accompanied by an arrangement or agreement under which the service recipient has an obligation or right to repurchase the acquired shares (including repurchases for an amount other than fair market value). In this context, the Treasury Department and the Service also request comments on appropriate techniques for valuation of stock subject to options or stock appreciation rights where the value of such stock is not established by and in an established securities market, in order to ensure that such valuation reflects the actual fair market value of the stock.

To the extent the additional guidance adopts a position on an issue addressed in this notice with respect to stock options or stock appreciation rights that is less favorable to taxpayers than provided in this notice, the Treasury Department and the Service anticipate that such a position will be applied only on a prospective basis with adequate transition relief to allow modification of plans to comply on a prospective basis.

C. Change in Control Events

This notice next addresses what constitutes a change in ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation (Change in Control Event) for purposes of § 409A. Section 885(e) of the Act requires that within 90 days of the enactment of the legislation, the Treasury Department and the Service issue guidance on what constitutes a Change in Control Event. Section 409A provides that, to the extent provided by the Treasury Department and the Service in guidance, a nonqualified deferred compensation plan may permit amounts deferred under the plan to be distributed upon a Change in Control Event.

D. Acceleration of Payments

Except under circumstances specified by the Treasury Department and the Service in guidance, a nonqualified deferred compensation plan may not permit the acceleration of payments under the plan. This notice provides circumstances under which payments under the plan may be accelerated, such as to meet the requirements of a domestic relations order or conflict of interest divestiture requirements. Comments are requested as to other circumstances under which a plan should be allowed to accelerate payments under the plan.

E. Effective Dates and Transition Relief

The notice provides guidance on the effective date provisions and transition relief. Section 409A generally is effective with respect to amounts deferred after December 31, 2004. Section 409A also is effective with respect to amounts deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. This notice addresses what amounts will be considered deferred after December 31, 2004, generally providing that an amount will be treated as deferred on or before December 31, 2004 only if the service recipient has a binding legal obligation to pay an amount in a future taxable year and the service provider's right to the amount is earned and vested as of December 31, 2004. Methods of calculating amounts treated as deferred on or before December 31, 2004 are provided. This notice also addresses when a plan under which a deferral is made will be considered materially modified after October 3, 2004.

This notice addresses the requirements of § 885(f) of the Act, which provides that within 60 days of the enactment of the legislation, the Treasury Department and the Service must issue guidance providing that for a limited period and under certain conditions, a nonqualified deferred compensation plan may be amended without violating certain provisions of § 409A to (i) allow a participant to terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, or (ii) conform the plan to the provisions of § 409A with respect to amounts deferred after December 31, 2004. This notice provides certain relief addressing the application of the initial deferral election requirements to compensation attributable, in whole or in part, to the performance of services in the years 2004 or 2005. This includes, for example, provisions addressing the deferral of bonuses, including bonuses for services performed in 2004.

F. Application of Information Reporting and Wage Withholding Requirements

This notice next addresses certain information reporting and wage withholding requirements imposed by § 885(b) of the Act with respect to deferred amounts. For information reporting purposes, the Act amends §§ 6041 and 6051 to require that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 (Miscellaneous Income) or a Form W-2 (Wage and Tax Statement). For wage withholding purposes, the Act amends § 3401(a) to provide that the term “wages” includes any amount includible in gross income of an employee under § 409A. Finally, for purposes of reporting nonemployee compensation, the Act further amends § 6041 to require that amounts includible in gross income under § 409A that are not treated as wages under § 3401(a) must be reported as gross income. This notice does not provide methods for calculating the amount of deferrals for the year or the amounts includible in gross income under § 409A and in wages under § 3401(a). Consequently, interim guidance is provided with respect to an employer's withholding and reporting obligations where the employer furnishes an expedited Form W-2 prior to the issuance of additional guidance providing such methods.

II. Reliance on Transition Guidance; Good Faith, Reasonable Interpretation

This notice provides rules governing the application of § 409A. The Treasury Department and the Service anticipate issuing additional guidance that incorporates this notice. To the extent the additional guidance adopts a position on an issue addressed in this notice that is less favorable to taxpayers than provided in this notice, the Treasury Department and the Service anticipate that such a position will be applied only on a prospective basis with adequate transition relief to allow modification of plans to comply on a prospective basis.

This notice does not provide comprehensive guidance with respect to the application of § 409A. Until additional guidance is issued, to comply with the requirements of § 409A with respect to issues not addressed in this notice, taxpayers should base their positions upon a good faith, reasonable interpretation of the statute and its purpose, which includes consideration of the legislative history. Whether a taxpayer position constitutes a good faith, reasonable interpretation of the statutory language generally will be determined based upon all of the relevant facts and circumstances, including whether the taxpayer has applied the position consistently and the extent to which the taxpayer has resolved unclear issues in the taxpayer's favor. In addition, certain provisions of § 409A provide definitive rules, but allow the Treasury Department and the Service to issue guidance providing exceptions to such rules. For example, § 409A(a)(3) provides that the Treasury Department and the Service may issue guidance providing an exception to the general prohibition against the acceleration of the time or schedule of any payment under a nonqualified deferred compensation plan. A taxpayer position based on an expected exception that the taxpayer speculates that the Treasury Department and the Service will adopt in future guidance is not a good faith, reasonable interpretation of the statutory language. In addition, as discussed above, the Treasury Department and the Service intend to issue guidance in 2005 providing methods for calculating the amount of deferrals for a year for purposes of all amounts of deferrals to which § 409A applies, including deferrals predating the issuance of the anticipated guidance. Accordingly, taxpayers will not be able to rely upon methods of calculation that differ from the methods provided in the 2005 guidance.

III. Request for Comments on Anticipated Guidance

A. Request for Comments

The Treasury Department and the Service request comments on all aspects of the application of § 409A, including but not limited to the topics addressed in this notice. The Treasury Department and the Service specifically request comments with respect to the following:

(1) The application of § 409A to severance plans, including whether to exclude any specific types of severance plans or arrangements (see Q&A 19).
(2) Funding arrangements for nonqualified deferred compensation that involve foreign trusts or similar arrangements, and identification of arrangements that will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors for purposes of the potential exemption from the provisions of § 409A(b) that the Treasury Department and the Service are authorized to provide under § 409A(e)(3).
(3) The application of § 409A to arrangements involving partners and partnerships. Comments are specifically requested with respect to the applicability of § 409A to arrangements subject to § 736, and whether there should be a distinction between payments subject to § 736(a) and (b) and the coordination of the timing rules of § 1.736-1(b)(5) with the rules of § 409A for nonqualified deferred compensation plans. Comments are also specifically requested on whether there should be special rules in applying § 409A in the case of a putative allocation and distribution which is recast, under § 707(a)(2)(A), as a payment to a nonpartner under § 707(a)(1).
(4) Potential additional exclusions from coverage under § 409A with respect to contractual arrangements between businesses (see Q&A 8).
(5) Situations where the acceleration of benefits should be permitted under § 409A(a)(3) (see Q&A 15), particularly in light of the legislative history regarding accelerated payments required for reasons beyond the control of the participant.

All materials submitted will be available for public inspection and copying.

B. Submission of Comments

Comments may be submitted to Internal Revenue Service, CC:PA:LPD:RU ( Notice 2005-1), Room 5203, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, NW, Washington DC 20224, Attn: CC:PA:LPD:RU ( Notice 2005-1), Room

5203. Submissions may also be sent electronically via the internet to the following email address: *Notice.comments@irscounsel.treas.gov*. Include the notice number ( Notice 2005-1) in the subject line.

IV. Guidance

A. Definitions and Coverage

Q-1 What does § 409A provide, in general?

A-1 Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

Q-2 What are the federal income tax consequences of a failure to satisfy the requirements of § 409A?

A-2 Generally, if at any time during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of § 409A, or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years, by any participant with respect to whom the failure relates, are includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If a deferred amount is required to be included in income under § 409A, the amount also is subject to interest and an additional income tax. The interest imposed is equal to the interest at the underpayment rate plus one percentage point, imposed on the underpayments that would have occurred had the compensation been includible in income for the taxable year when first deferred, or if later, when not subject to a substantial risk of forfeiture. The additional income tax is equal to 20 percent of the compensation required to be included in gross income.

Q-3 What is a nonqualified deferred compensation plan?

A-3 (a) In general. Except as otherwise provided in this A-3, the term nonqualified deferred compensation plan means any plan (within the meaning of Q&A 9) that provides for the deferral of compensation (within the meaning of Q&A 4). The application of § 409A is not limited to arrangements between an employer and an employee. For example, § 409A may apply to arrangements between a service recipient and an independent contractor, or arrangements between a partner and a partnership (see Q&A 7 and Q&A 8).

(b) Qualified employer plans. The term nonqualified deferred compensation plan does not include (i) any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of § 219(g)(5) (without regard to subparagraph (A)(iii)), (ii) any eligible deferred compensation plan (within the meaning of § 457(b)), and (iii) any plan described in § 415(m). Accordingly, the term nonqualified deferred compensation plan does not include a qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE or § 501(c)(18) trust.

(c) Certain welfare benefits. The term nonqualified deferred compensation plan does not include any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. For these purposes, the term disability pay has the same meaning as provided in § 31.3121(v)(2)-1(b)(4)(iv)(C) of the Employment Tax Regulations, and the term death benefit plan refers to a plan providing death benefits as defined in § 31.3121(v)(2)-1(b)(4)(iv)(C). The term nonqualified deferred compensation plan also does not include any Archer Medical Savings Account as described in § 220, any Health Savings Account as described in § 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of § 105 and § 106.

Q-4 What constitutes a deferral of compensation?

A-4 (a) Deferral of compensation defined. A plan provides for the deferral of compensation only 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 has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is 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 if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition that is unlikely to occur, or the discretion to reduce or eliminate the compensation is unlikely to be exercised, a service provider will be considered to have a legally binding right to the compensation. For this purpose, compensation 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 an objective provision creating a substantial risk of forfeiture (within the meaning of Q&A 10). Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under § 401(a), or because benefits are reduced due to actual or notional investment losses, or in a final average pay plan, subsequent decreases in compensation.

(b) Compensation payable pursuant to the service recipient's customary payment timing arrangement. A deferral of compensation does not occur solely because compensation is paid after the last day of the service provider's taxable year pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in § 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in § 3401(b).

(c) Short-term deferrals. Until additional guidance is issued, a deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later period, at all times the terms of the plan require payment by, and an amount is actually or constructively received by the service provider by, the later of (i) the date that is 2 1/2 months from the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Q&A 10) or (ii) the date that is 2 1/2 months from the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (as defined in Q&A 10). For these purposes, an amount that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the date the service provider has a legally binding right to the amount. For example, an employer with a calendar year taxable year who on November 1, 2006 awards a bonus so that the employee is considered to have a binding legally binding right to the payment as of November 1, 2006, will not be considered to have provided for a deferral of compensation if, in accordance with the terms of the bonus plan, the amount is paid or made available to the employee on or before March 15, 2007. An employer with a September 1 to August 31 taxable year who on November 1, 2006 awards a bonus so that the employee is considered to have a legally binding right to the payment as of November 1, 2006, will not be considered to have provided for a deferral of compensation if, in accordance with the terms of the bonus plan, the amount is paid or made available to the employee on or before November 15, 2007. Notwithstanding the foregoing, if an election is provided to the service provider with respect to the taxable year in which payment of the compensation will occur, and the service provider elects a taxable year later than the taxable year in which he or she obtained a legally binding right to the payment, the arrangement constitutes a deferral of compensation subject to § 409A, including the deferral election timing rules of § 409A(a)(4). In addition, the arrangement continues to be subject to applicable U.S. Federal tax principles which may require immediate income inclusion.

(d) Stock options, stock appreciation rights, and other equity-based compensation. (i) Except as provided in paragraphs (ii), (iii) and (iv), the grant of a stock option, stock appreciation right or other equity-based compensation provides for a deferral of compensation subject to § 409A. Stock appreciation rights generally will be covered by § 409A; however, stock appreciation rights may be structured to comply with the provisions of § 409A. For example, the terms of a stock appreciation right with a fixed payment date generally will comply with the provisions of § 409A.

(ii) Nonstatutory stock options. An option to purchase stock of the service recipient, other than an incentive stock option described in § 422 or an option granted under an employee stock purchase plan described in § 423, does not provide for a deferral of compensation if: (1) the amount required to purchase stock under the option (the exercise price) may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the receipt, transfer or exercise of the option is subject to taxation under § 83, and (3) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under § 1.83-7. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock option does not constitute a feature for the deferral of compensation. If under the terms of the option, the amount required to purchase the stock is or could become less than the fair market value of the stock on the date of grant, the grant of the stock option may provide for the deferral of compensation within the meaning of this A-4. For purposes of determining the fair market value of the stock at the date of grant, any reasonable valuation method may be used. Such methods include, for example, the valuation method described in § 20.2031-2 of the Estate Tax Regulations. To the extent an arrangement grants the recipient a right other than to purchase stock at a defined price and such additional rights allow for the deferral of compensation (for example, tandem arrangements involving options and stock appreciation rights), the entire arrangement provides for the deferral of compensation. If the requirements of § 1.424-1 would be met if the nonstatutory option were a statutory option, the substitution of a new option pursuant to a corporate transaction for an outstanding option or the assumption of an outstanding option will not be treated as the grant of a new option or a change in the form of payment for purposes of § 409A. For purposes of the preceding sentence, the requirement of § 1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the option price to the fair market value of the shares subject to the option immediately after the substitution or assumption is not greater than the ratio of the option price to the fair market value of the shares subject to the option immediately before the substitution or assumption.

(iii) Statutory stock options. The grant of an incentive stock option as described in § 422, or the grant of an option under an employee stock purchase plan described in § 423 (including the grant of an option with an exercise price discounted in accordance with § 423(b)(6) and the accompanying regulations), does not constitute a deferral of compensation.

(iv) Certain stock appreciation rights. A stock appreciation right with respect to stock of the service recipient does not provide for a deferral of compensation if: (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, (2) the stock of the service recipient subject to the right is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement of the right upon exercise, and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock appreciation right does not constitute a feature for the deferral of compensation. If, under the terms of the stock appreciation right, the SAR exercise price is or could become less than the fair market value of the underlying stock on the date of grant, the right may be settled upon exercise in a medium other than the traded stock of the service recipient, or there is an agreement or arrangement under which the service recipient will purchase the stock delivered in settlement of the right upon exercise, then the grant of the stock appreciation right may provide for the deferral of compensation within the meaning of this A-4. In addition, until further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

(e) Restricted property. If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income (under § 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or is includible in income (under § 83) solely due to a valid election under § 83(b). However, a plan under which a service provider obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. For purposes of this paragraph, a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to § 83, § 402(b) or § 403(c).

(f) Earnings. References to the deferral of compensation include references to income (whether actual or notional) attributable to such compensation or such income.

Q-5 Who is the service recipient?

A-5 For purposes of § 409A, the service recipient refers to the person for whom the services are performed, and all persons with whom such person would be considered a single employer under § 414(b) (employees of controlled group of corporations), and all persons with whom such person would be considered a single employer under § 414(c) (employees of partnerships, proprietorships, etc., which are under common control).

Q-6 How Does § 409A Apply to Arrangements Covered by § 457?

A-6 The rules of § 409A apply to nonqualified deferred compensation plans under § 457(f) in addition to any requirements already applicable to such plans under § 457(f). Eligible plans under § 457(b) are not subject to the requirements of § 409A. However, nonelective deferred compensation of nonemployees described in § 457(e)(12) and grandfathered plans under prior § 457 transition rules generally are subject to § 409A. Pending additional guidance, length of service awards to bona fide volunteers under § 457(e)(11)(A)(ii) are not subject to § 409A. Further, pending additional guidance, State and local government and tax exempt entities may rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans for purposes of § 457(f) as applicable for purposes of applying § 409A to nonqualified deferred compensation plans under § 457(f). However, State and local government and tax exempt entities may not rely upon the definition of a deferral of compensation for purposes of § 409A as applicable for purposes of the § 457(f) definition of a deferral of compensation. For example, for purposes of § 457(f), a deferral of compensation includes stock options (whether nonstatutory or under § 422 or § 423) and arrangements in which an employee or independent contractor of a State or local government or tax-exempt entity earns the right to future payments for services, even if those amounts are paid immediately upon vesting.

Q-7 How Does § 409A Apply to Arrangements Between a Partnership and a Partner of the Partnership?

A-7 The application of § 409A is not limited to arrangements between an employer and employee. Accordingly, § 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan. However, until additional guidance is issued, for purposes of § 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock (see Q&A 4). Specifically, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a profits interest in connection with the performance of services that is properly treated under applicable guidance as not resulting in inclusion of income by the service provider at the time of issuance, as also not resulting in the deferral of compensation. Similarly, until additional guidance is issued, for purposes of § 409A, taxpayers may treat an issuance of a capital interest in connection with the performance of services in the same manner as an issuance of stock. The § 409A rules governing other stock-based compensation may be applied by analogy to grants of equity-based compensation where the compensation is determined by reference to partnership equity. In addition, until further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A. Finally, § 409A may apply to payments covered by § 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

Q-8 To Which Service Providers Does § 409A Apply?

A-8 Until additional guidance is issued, a service provider for purposes of § 409A includes (i) an individual, (ii) a personal service corporation (as defined in § 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, or (iii) a qualified personal service corporation (as defined in § 448(d)(2)), or a noncorporate entity that would be a qualified personal service corporation if it were a corporation. Section 409A does not apply to arrangements between taxpayers all of whom use the accrual method of accounting. Section 409A also does not apply to arrangements between a service provider and a service recipient if (a) the service provider is actively engaged in the trade or business of providing substantial services, other than (I) as an employee or (II) as a director of a corporation; and (b) the service provider provides such services to two or more service recipients to which the service provider is not related and that are not related to one another. For purposes of the preceding sentence, a person is related to another person if (i) the persons bear a relationship to each other that is specified in § 267(b) or 707(b)(1), subject to the modifications that the language “20 percent” is used instead of “50 percent” each place it appears in §§ 267(b) and 707(b)(1), and § 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or (ii) the persons are engaged in trades or businesses under common control (within the meaning of § 52(a) and (b)). The Treasury Department and the Service intend to issue additional guidance addressing types of service providers not subject to § 409A.

Q-9 What constitutes a plan?

A-9 A plan includes any agreement, method or arrangement, including an agreement, method or arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated among or agreed to by the service recipient and one or more service providers or service provider representatives. An agreement, method or arrangement may constitute a plan regardless of whether it is an employee benefit plan under § 3(3) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended (29 U.S.C. 1002(3)). Unless otherwise specified in this notice, the requirements of § 409A are applied as if (a) a separate plan or plans is maintained for each service provider, and (b) all compensation deferred with respect to a particular service provider under an account balance plan (as defined in § 31.3121(v)(2)-1(c)(1)(ii)(A)) is treated as deferred under a single plan, all compensation deferred under a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)(i)) is treated as deferred under a separate single plan, and all compensation deferred under a plan that is neither an account balance plan nor a nonaccount balance plan (for example, discounted stock options, stock appreciation rights or other equity-based compensation described in § 31.3121(v)(2)-1(b)(4)(ii)) is treated as deferred under a separate single plan. For these purposes a severance plan is either an account balance plan or a nonaccount balance plan, determined in accordance with the rules of this A-9.

Q-10 When is an amount subject to a substantial risk of forfeiture?

A-10 (a) Definition. Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of this A-10, a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of § 409A, an amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive. For example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. However, where an election is granted to receive a materially greater bonus amount in a future year rather than a materially lesser bonus amount in an earlier year, the materially greater bonus may be made subject to a substantial risk of forfeiture.

(b) Enforcement of forfeiture condition. In determining whether the possibility of forfeiture is substantial in the case of rights to compensation granted to a service provider by the service recipient corporation, where the service provider owns a significant amount of the total combined voting power or value of all classes of stock of the service recipient corporation or of its parent corporation, there will be taken into account (i) the service provider's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the service provider in the corporation and the extent to which the service provider is subordinate to other service providers, (iii) the service provider's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the service provider's discharge, and (v) past actions of the service recipient in enforcing the restrictions. For example, if a service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on the right to deferred compensation of the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

B. Change in Control Events

Q-11 Under what circumstances will payments be permitted upon a change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation?

A-11 (a) In general. Pursuant to § 409A(a)(2)(A)(v), a plan may permit a payment upon the occurrence of a change in the ownership of the corporation (as defined in Q&A 12), a change in effective control of the corporation (as defined in Q&A 13), or a change in the ownership of a substantial portion of the assets of the corporation (as defined in Q&A 14) (collectively referred to as a Change in Control Event). To qualify as a Change in Control Event, the occurrence of the event must be objectively determinable and any requirement that any other person, such as a plan administrator or board of directors compensation committee, certify the occurrence of a Change in Control Event must be strictly ministerial and not involve any discretionary authority. For purposes of this paragraph (a), a payment also will be treated as occurring upon a Change in Control Event if the right to the payment arises due to the corporation's exercise of discretion under the terms of the plan to terminate the plan and distribute the compensation deferred thereunder within 12 months of the Change in Control Event. The plan may provide for a payment on any Change in Control Event, and need not provide for a payment on all such events, provided that each event upon which a payment is provided qualifies as a Change in Control Event.

(b) Identification of relevant corporation(s). To constitute a Change in Control Event as to the plan participant, the Change in Control Event must relate to (i) the corporation for whom the participant is performing services at the time of the Change in Control Event, (ii) the corporation that is liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable), or (iii) a corporation that is a majority shareholder of a corporation identified in (i) or (ii), or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in (i) or (ii). For example, assume Corporation A is a majority shareholder of Corporation B, which is a majority shareholder of Corporation C. A change in ownership of Corporation B will constitute a Change in Control Event to plan participants performing services for Corporation B or Corporation C, and to plan participants for which Corporation B or Corporation C is solely liable for payments under the plan (for example, former employees), but will not constitute a Change in Control Event as to Corporation A or any other corporation of which Corporation A is a majority shareholder. Notwithstanding the foregoing, a sale of Corporation B may constitute an independent Change in Control Event for Corporation A, Corporation B and Corporation C if the sale constitutes a change in the ownership of a substantial portion of Corporation A's assets (see Q&A 14). For purposes of this paragraph, a majority shareholder is a shareholder owning more than 50% of the total fair market value and total voting power of such corporation.

(c) Attribution of stock ownership. For purposes of this A-11, Q&A 12, Q&A 13 and Q&A 14, § 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if a vested option is exercisable for stock that is not substantially vested (as defined by §§ 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this paragraph (c).

Q-12 What is a change in the ownership of a corporation?

A-12 (a) Change in the ownership of a corporation. For purposes of § 409A, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b)), acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q&A 13)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A-12 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction (see Q&A 14 for rules regarding the transfer of assets of a corporation).

(b) Persons acting as a group. For purposes of paragraph (a), persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See § 1.280G-1, Q&A 27(d), Example 4.

(c) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

Q-13 What is a change in the effective control of a corporation?

A-13 (a) Change in the effective control of the corporation. For purposes of § 409A, notwithstanding that a corporation has not undergone a change in ownership under Q&A 12, a change in the effective control of a corporation occurs on the date that either -

(i) Any one person, or more than one person acting as a group (as determined under paragraph (iv)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 35 percent or more of the total voting power of the stock of such corporation; or
(ii) a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election, provided that for purposes of this paragraph (ii) the term corporation refers solely to the relevant corporation identified in Q&A 11, paragraph (b) for which no other corporation is a majority shareholder for purposes of that paragraph (for example, if Corporation A is a publicly held corporation with no majority shareholder, and Corporation A is the majority shareholder of Corporation B, which is the majority shareholder of Corporation C, the term corporation for purposes of this paragraph (ii) would refer solely to Corporation A).

In the absence of an event described in paragraph (i) or (ii), a change in the effective control of a corporation will not have occurred.

(b) Multiple Change in Control Events. A change in effective control also may occur in any transaction in which either of the two corporations involved in the transaction has a Change in Control Event under A-12 or A-14. Thus, for example, assume Corporation P transfers more than 40 percent of the total gross fair market value of its assets to Corporation O in exchange for 35 percent of O's stock. P has undergone a change in ownership of a substantial portion of its assets under A-14 and O has a change in effective control under this A-13.

(c) Acquisition of additional control. If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A-13), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q&A 12).

(d) Persons acting as a group. Persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(e) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

Q-14 What is a change in the ownership of a substantial portion of a corporation's assets?

A-14 (a) Change in the ownership of a substantial portion of a corporation's assets. For purposes of § 409A, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40 percent of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

(b) Transfers to a related person. There is no Change in Control Event under this A-14 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to -

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;
(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;
(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or
(iv) An entity, at least 50 percent of the total value or voting power of which is owned, directly or indirectly, by a person described in paragraph (iii).

For purposes of this paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) Persons acting as a group. Persons will not be considered to be acting as a group solely because they purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) Stock ownership. For purposes of determining stock ownership, see Q&A 11.

C. Acceleration of Payments

Q-15 Under what conditions may a plan permit the acceleration of the time or schedule of any payment under the plan?

A-15 (a) In general. Except as provided in paragraphs (b) through (f) below, a plan may not permit the acceleration of the time or schedule of any payment under the plan. It is not an acceleration of the time or schedule of payment of a deferral of compensation if a service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture applicable to such deferral of compensation, provided that the requirements of § 409A are otherwise satisfied with respect to such deferral of compensation. For example, if a nonqualified deferred compensation plan provides for a lump sum payment of the vested benefit upon separation from service, and the benefit vests under the plan only after 10 years of service, it is not a violation of the requirements of § 409A if the service recipient reduces the vesting requirement to 5 years of service, even if a service provider becomes vested as a result and qualifies for a payment in connection with a separation from service.

(b) Domestic relations order. A plan may permit such acceleration of the time or schedule of a payment under the plan to an individual other than the plan participant as may be necessary to fulfill a domestic relations order (as defined in § 414(p)(1)(B)).

(c) Conflicts of interest. A plan may permit such acceleration of the time or schedule of a payment under the plan as may be necessary to comply with a certificate of divestiture (as defined in § 1043(b)(2)).

(d) Section 457 plans. A plan subject to § 457(f) may permit an acceleration of the time or schedule of a payment to a participant to pay income taxes due upon a vesting event, provided that the amount of such payment is not more than an amount equal to the income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the participant under § 457(f) at the time of the vesting.

(e) De minimis and specified amounts. A plan that does not otherwise provide for de minimis cashout payments may be amended to permit the acceleration of the time or schedule of a payment to a participant under the plan, provided that (i) the payment accompanies the termination of the entirety of the participant's interest in the plan; (ii) the payment is made on or before the later of (A) December 31 of the calendar year in which occurs the participant's separation from service from the service recipient or (B) the date 2 1/2 months after the participant's separation from service from the service recipient; and (iii) the payment is not greater than $10,000. Such an amendment may be made with respect to previously deferred amounts under the plan as well as amounts to be deferred in the future. In addition, a nonqualified deferred compensation plan that otherwise complies with § 409A may be amended with regard to future deferrals to provide that, if a participant's interest under the plan has a value below an amount specified by the plan at the time that amounts are payable under the plan, then the participant's entire interest under the plan shall be distributed as a lump sum payment.

(f) Payment of employment taxes. A plan may permit the acceleration of the time or schedule of a payment to pay the Federal Insurance Contributions Act (FICA) tax imposed under § 3101 and § 3121(v)(2) on compensation deferred under the plan (the FICA Amount). Additionally, a plan may permit the acceleration of the time or schedule of a payment to pay the income tax at source on wages imposed under § 3401 on the FICA Amount, and to pay the additional income tax at source on wages attributable to the pyramiding § 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the FICA Amount, and the income tax withholding related to such FICA amount.

(g) Definition of plan. For purposes of this A-15, the term plan has the meaning provided in Q&A 9, except that the provisions treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

D. Effective Dates and Transition Guidance

Q-16 When does section 409A become effective?

A-16 (a) In general. Except as provided in Q&As 19 through 23, § 409A is effective with respect to (i) amounts deferred in taxable years beginning after December 31, 2004; and (ii) amounts deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. Section 409A is effective with respect to earnings on amounts deferred only to the extent that § 409A is effective with respect to the amounts deferred. Accordingly, § 409A is not effective with respect to earnings on amounts deferred before January 1, 2005 unless § 409A is effective with respect to the amounts deferred.

(b) Date of deferral for effective date purposes. For purposes of determining whether § 409A is effective with respect to an amount, the amount is considered deferred before January 1, 2005 if (i) the service provider has a legally binding right to be paid the amount and (ii) the right to the amount is earned and vested. For purposes of this A-16, a right to an amount is earned and vested only if the amount is not subject to either a substantial risk of forfeiture (as defined in § 1.83-3(c)) or a requirement to perform further services. Accordingly, amounts to which the service provider does not have a legally binding right before January 1, 2005 (for example because the service recipient retains discretion to reduce the amount), will not be considered deferred before January 1, 2005. In addition, amounts to which the service provider has a legally binding right before January 1, 2005, but the right to which is subject to a substantial risk of forfeiture or a requirement to perform further services after December 31, 2004 are not considered deferred before January 1, 2005 for purposes of the effective date. Notwithstanding the foregoing, an amount to which the service provider has a legally binding right before January 1, 2005, but for which the service provider must continue performing services to retain the right only through the completion of the payroll period (as defined in Q&A 4) which includes December 31, 2004, shall not be treated as subject to a requirement to perform further services (or a substantial risk of forfeiture) for purposes of the effective date.

Q-17 For purposes of the effective date, how is the amount of compensation deferred under a nonqualified deferred compensation plan before January 1, 2005 determined?

A-17 (a) Nonaccount balance plans. The amount of compensation deferred before January 1, 2005 under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)(i)) equals the present value as of December 31, 2004 of the amount to which the participant would be entitled under the plan if the participant voluntarily terminated services without cause on December 31 of that taxable year, and received a full payment of benefits from the plan on the earliest possible date allowed under the plan following the termination of services, to the extent the right to the benefit is earned and vested (as defined in Q&A 16) as of December 31, 2004. For purposes of determining the present value of the benefit, the actuarial assumptions contained within the plan are used provided such assumptions are reasonable; otherwise, reasonable actuarial assumptions must be used. Amounts to which the participant would not be entitled upon termination, such as early retirement subsidies for which the participant would not have attained sufficient service if he or she terminated services on December 31, 2004, are not includible as compensation deferred under the plan as of December 31, 2004.

 

(b) Account balance plans. The amount of compensation deferred before January 1, 2005 under a nonqualified deferred compensation plan that is an account balance plan (as defined in § 31.3121(v)(2)-1(c)(1)(ii)) equals the portion of the participant's account balance as of December 31, 2004 the right to which is earned and vested (as defined in Q&A 16) as of December 31, 2004.

(c) Equity-based compensation plans. For purposes of determining the amounts deferred before January 1, 2005 under an equity-based compensation plan, the rules of paragraph (b) governing account balance plans are applied except that the account balance is deemed to be the amount of the payment available to the participant on December 31, 2004 (or that would be available to the participant if the right were immediately exercisable) the right to which is earned and vested (as defined in Q&A 16) as of December 31, 2004. For this purpose, the payment available to the participant excludes any exercise price or other amount which must be paid by the participant.

(d) Earnings. Earnings on amounts deferred under a plan before January 1, 2005 include only income (whether actual or notional) attributable to the amounts deferred under a plan as of December 31, 2004 or such income. For example, notional interest earned under the plan on amounts deferred in an account balance plan as of December 31, 2004 generally will be treated as earnings on amounts deferred under the plan before January 1, 2005. Similarly, an increase in the amount of payment available under a stock option, stock appreciation right or other equity-based compensation above the amount of payment available as of December 31, 2004, due to appreciation in the underlying stock after December 31, 2004, is treated as earnings on the amount deferred. In the case of a nonaccount balance plan, earnings include the increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amounts deferred under the plan before January 1, 2005. Thus, for each year, there will be an increase (determined using the same interest rate used to determine the amounts deferred under the plan before January 1, 2005) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. However, an increase in the potential benefits under a nonaccount balance plan due to, for example, an application of an increase in compensation after December 31, 2004 to a final average pay plan or subsequent eligibility for an early retirement subsidy, does not constitute earnings on the amounts deferred under the plan before January 1, 2005.

(e) Definition of plan. For purposes of this A-17, the term plan has the same meaning provided in Q&A 9, except that the provisions treating all nonaccount balance plans under which compensation is deferred as a single plan does not apply for purposes of the actuarial assumptions used in paragraph (b). Accordingly, different reasonable actuarial assumptions may be used to calculate the amounts deferred by a participant in two different arrangements each of which constitutes a nonaccount balance plan.

Q-18 When is a plan materially modified?

A-18 (a) In general. Except as otherwise provided in this A-18 and Q&A 19, a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. Such benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or the service recipient's exercise of discretion under the terms of the plan. For example, an amendment to a plan to add a provision that payments may be allowed upon request if participants are required to forfeit 10 percent of the amount of the payment (a “haircut”) would be a material modification to the plan. Similarly, a material modification would occur if a service recipient exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004. However, it is not a material modification for a service recipient to exercise discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004. Also, it is not a material modification to change a notional investment measure to, or to add, an investment measure that qualifies as a predetermined actual investment within the meaning of § 31.3121(v)(2)-1(d)(2). It is not a material modification for a participant to exercise a right permitted under the plan as in effect on October 3, 2004. The amendment of a plan to bring the plan into compliance with the provisions of § 409A will not be treated as a material modification. However, a plan amendment or the exercise of discretion under the terms of the plan that enhances an existing benefit or right or adds a new benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under § 409A. For example, the addition of a right to a payment upon an unforeseeable emergency would be considered a material modification. The reduction of an existing benefit is not a material modification. For example, the removal of a “haircut” provision generally would not constitute a material modification.

(b) Adoption of new arrangement. It is presumed that the adoption of a new arrangement or the grant of an additional benefit under an existing arrangement after October 3, 2004 will constitute a material modification of a plan. However, the presumption may be rebutted by demonstrating that the adoption of the arrangement or grant of the additional benefit is consistent with the service recipient's historical compensation practices. For example, the presumption that the grant of a stock appreciation right on November 1, 2004 is a material modification of a plan may be rebutted by demonstrating that the grant was consistent with the historic practice of granting substantially similar stock appreciation rights (both as to terms and amounts) each November for a significant number of years. Notwithstanding paragraph (a) and this paragraph (b), the grant of an additional benefit under an existing arrangement that consists solely of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004 will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to § 409A. A plan may be amended to comply with the provisions of the preceding sentence in accordance with the rules of Q&A 19.

(c) Suspension or termination of a plan. Amending an arrangement to stop future deferrals thereunder is not a material modification of the arrangement or the plan. Amending an arrangement on or before December 31, 2005 to terminate the arrangement and distribute the amounts of deferred compensation thereunder will not be treated as a material modification, provided that all amounts deferred under the plan are included in income in the taxable year in which the termination occurs.

(d) Equity-based compensation. Provided that the cancellation and reissuance occurs on or before December 31, 2005, it will not be a material modification to replace a stock option or stock appreciation right otherwise providing for a deferral of compensation under Q&A 4 with a stock option or stock appreciation right that would not have constituted a deferral of compensation under § 409A if it had been granted upon the original date of grant of the replaced stock option or stock appreciation right. The preceding sentence only applies if (i) the number of shares which form the basis of the new stock option or new stock appreciation right corresponds directly to the number of shares subject to the original stock option or stock appreciation right; and (ii) the new stock option or new stock appreciation right does not provide any additional benefit to the service recipient (other than the benefit directly due to a change in form of the award to a form not treated as a deferral of compensation). A replacement stock option or replacement stock appreciation right will be treated as meeting the requirements of clause (i) of the preceding sentence if the new grant is made in accordance with the principles of § 1.424-1(a)(5) except to the extent necessary to ensure that the new grant does not violate § 409A. For example, a stock option originally issued with an exercise price discounted below the value of the shares subject to the option on the date of grant could be amended, without causing a material modification of the option, to be excluded from the definition of deferral of compensation by eliminating the discount on the exercise price below the value of the shares subject to the option on the original date of grant. Similarly, a stock appreciation right could be converted to a stock option or stock appreciation right that, based on its terms, would be excluded from the definition of deferral of compensation.

(e) Definition of plan. For purposes of this A-18, the term plan has the same meaning provided in Q&A 9, except that the provision treating all account balance plans under which compensation is deferred as a single plan, all nonaccount balance plans under which compensation is deferred as a separate single plan, and all other nonqualified deferred compensation plans as a separate single plan, does not apply.

Q-19 Under what conditions may a plan adopted before December 31, 2005 be operated and amended without violating the requirements of section 409A(a)(2), (3) and (4)?

A-19 (a) In general. A plan adopted before December 31, 2005 will not be treated as violating § 409A(a)(2), (3) or (4) only if (i) the plan is operated in good faith compliance with the provisions of § 409A and this notice during the calendar year 2005, and (ii) the plan is amended on or before December 31, 2005 to conform to the provisions of § 409A with respect to amounts subject to § 409A.

(b) Good faith compliance. A plan will be treated as operated in good faith compliance during the calendar year 2005 if it is operated in accordance with the terms of this notice and, to the extent an issue is not addressed in this notice, a good faith, reasonable interpretation of § 409A, and, to the extent not inconsistent therewith, the plan's terms, provided that the plan sponsor does not exercise discretion under the terms of the plan, or that a participant does not exercise discretion with respect to that participant's benefits, in a manner that causes the plan to fail to meet the requirements of § 409A. For example, if an employer retains the discretion under the terms of the plan to delay or extend payments under the plan and exercises such discretion, the plan will not be considered to be operated in good faith compliance with § 409A with regard to any plan participant. However, an exercise of a right under the terms of the plan by a plan participant solely with respect to that participant's benefits under the plan, in a manner that causes the plan to fail to meet the requirements of § 409A, will not be considered to result in the plan failing to be operated in good faith compliance with respect to other participants. For example, the request for and receipt of an immediate payment permitted under the terms of the plan if the participant forfeits 10% of the participant's benefits (a “haircut”) will be considered a failure of the plan to meet the requirements of § 409A with respect to that participant, but not with respect to all participants under the plan.

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

(d) Severance plans. Provided that the plans are otherwise amended in compliance with paragraph (a), a plan that provides severance pay benefits, and that is either (i) a collectively bargained plan or (ii) covers no service providers who are key employees (as defined in § 416(i) and the regulations thereunder), is not required to meet the requirements of § 409A during the calendar year 2005 with respect to such severance pay benefits. Benefits that are provided under a severance pay arrangement (within the meaning of § 3(2)(B)(i) of ERISA (29 U.S.C. § 1002(2)(B)(i)) that satisfies the conditions in 29 CFR § 2510.3-2(b)(1)(i) through (iii) are considered severance pay for purposes of this paragraph (d). Benefits provided under a severance pay arrangement (within the meaning of § 3(2)(B)(i) of ERISA) are in all cases severance pay within the meaning of this paragraph (d) if the benefits payable under the plan upon an employee's termination of employment are payable only if that termination is involuntary.

Q-20 Under what conditions may a plan adopted before December 31, 2005 provide a participant a right to terminate participation in the plan, or cancel an outstanding deferral election with regard to amounts subject to § 409A, and receive a payment of amounts subject to the termination or cancellation, without violating the requirements of § 409A(a)(2), (3) and (4)?

A-20 (a) Plan amendment. A plan adopted before December 31, 2005 may be amended to allow a participant during all or part of the calendar year 2005 to terminate participation in the plan or cancel a deferral election, without causing the plan to fail to conform to the provisions of § 409A(a)(2), (3) or (4), provided that (i) the amendment is enacted and effective on or before December 31, 2005, and (ii) the amounts subject to the termination or cancellation are includible in income of the participant in the calendar year 2005, or if later, the taxable year in which the amounts are earned and vested (as defined in Q&A 16). Solely for purposes of effecting the relief provided in this A-20, neither the availability of the election to the participant nor the making of the election by the participant will be treated as resulting in a violation of the requirements of § 409A(a)(2), (3) or (4) or causing amounts the participant continues to defer to be includible in income under § 451 or the doctrine of constructive receipt (although these provisions may still apply for other reasons). There is no requirement that the opportunity to terminate participation in a plan or to cancel a deferral election be granted, or that if granted, be granted to all plan participants. A termination or cancellation may be made with respect to elective or nonelective deferred compensation and may be undertaken by the service recipient or at the election of the participant. A termination or cancellation under this paragraph may apply in whole or in part to one or more plans in which a participant participates and to one or more outstanding deferral elections the participant has made with regard to amounts subject to § 409A.

(b) Payments. Provided that the plan amendment is adopted in accordance with paragraph (a), a provision permitting a payment to a participant during calendar year 2005 or, if later, the taxable year in which the amount is earned and vested (as defined in Q&A 16), upon a termination of participation in the plan or the cancellation of a deferral election with regard to amounts subject to § 409A, will not be treated as causing a plan to violate the provisions of § 409A(a)(2), (3) or (4), and a payment from a plan pursuant to such an amendment will not be treated as a violation of the provision of § 409A(a)(2), (3) or (4), provided that the full amount of the distribution is included in the participant's income in calendar year 2005 or, if later, the participant's taxable year in which the amount is earned and vested (as defined in Q&A 16).

(c) Partial terminations and cancellations. For purposes of this Q&A 20, the termination of participation in the plan or the cancellation of an outstanding deferral election with regard to amounts subject to § 409A includes a termination or cancellation that results in a lower amount of deferrals for the period, without a complete elimination of the deferrals.

(d) Definition of plan. For purposes of this A-20, the definition of plan under Q&A 9 applies, except that the rule requiring the aggregation of all account balance plans, all nonaccount balance plans, and all other plans does not apply.

Q-21 Under what conditions will deferral elections under a plan in existence on or before December 31, 2004, made with respect to deferrals relating all or in part to services performed on or before December 31, 2005, be exempt from the requirements of § 409A(a)(4)(B) relating to the timing of elections?

A-21 With respect to deferrals subject to § 409A that relate all or in part to services performed on or before December 31, 2005, the requirements of § 409A(a)(4)(B) relating to the timing of elections will not be applicable to any elections made on or before March 15, 2005, provided that (a) the amounts to which the deferral election relate have not been paid or become payable at the time of election, (b) the plan under which the deferral election is or was made was in existence on or before December 31, 2004, (c) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005 (other than a requirement to make a deferral election after March 15, 2005), (d) the plan is otherwise operated in accordance with § 409A with respect to deferrals subject to § 409A and (e) the plan is amended to comply with the requirements of § 409A in accordance with Q&A 19. For purposes of this A-21, a nonqualified deferred compensation plan will be treated as in existence before December 31, 2004 only if a written plan document (a) identifies a specific amount or type of compensation that is subject to the plan and not otherwise payable at the time of the deferral election, and (b) provides that a participant in the plan may elect to defer the compensation beyond the taxable year in which the amount otherwise would have been payable. Solely for purposes of effecting the relief provided in this A-21, neither the availability of the election to the participant nor the making of the election by the participant will be treated as causing amounts the participant defers to be includible in income under § 451 or the doctrine of constructive receipt.

Q-22 Until additional guidance is issued, under what conditions may deferral elections be made with respect to bonus compensation?

A-22 Section 409A(a)(4)(B)(iii) provides that in the case of any performance-based compensation based on services performed over a period of at least 12 months, an election to defer such compensation may be made no later than 6 months before the end of the period. The Treasury Department and the Service anticipate issuing guidance that sets forth the requirements for compensation to qualify as performance-based compensation. The Treasury Department and the Service anticipate that those requirements will be more restrictive than the requirements outlined in this A-22. Until additional guidance is issued, a deferral election with respect to bonus compensation based on services performed over a period of at least 12 months will be treated as meeting the requirements of § 409A(a)(4) if the election is made at least 6 months before the end of the service period. For purposes of this transition relief, the term bonus compensation refers to compensation where (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. Bonus compensation may include payments based upon subjective performance criteria, but (i) any subjective performance criteria must relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and (ii) the determination that any subjective performance criteria have been met must not be made by the participant service provider or a family member of the participant service provider (as defined in § 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family). Bonus compensation may also include payments based on performance criteria that are not approved by a compensation committee of the board of directors (or similar entity in the case of a non-corporate service recipient) or by the stockholders or members of the service recipient. Notwithstanding the foregoing, bonus compensation does not include any amount or portion of any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria is established, or that is based solely on the value of, or appreciation in value of, the service recipient or the stock of the service recipient.

Q-23 Under what circumstances will payments be permitted based upon elections under a qualified plan for periods ending on or before December 31, 2005.

A-23 For periods ending on or before December 31, 2005, an election as to the timing and form of a payment under a nonqualified deferred compensation plan that is controlled by a payment election made by the participant under a qualified plan will not violate § 409A, provided that the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that govern payments. For purposes of this paragraph, a qualified plan means a retirement plan qualified under § 401(a). For example, where a nonqualified deferred compensation plan provides as of October 3, 2004 that the time and form of payment to a participant will be the same time and form of payment elected by the participant under a related qualified plan, it will not be a violation of § 409A for the plan administrator to make or commence payments under the nonqualified deferred compensation plan on or after January 1, 2005 and on or before December 31, 2005 pursuant to the payment election under the related qualified plan. Notwithstanding the foregoing, other provisions of the Code and common law tax doctrines continue to apply to any election as to the timing and form of a payment under a nonqualified deferred compensation plan.

E. Information Reporting Requirements for Deferred Amounts

Q-24 What information reporting requirements are imposed by § 885(b) of the Act?

A-24 The Act adds §§ 6041(g)(1) and 6051(a)(13), which require that all deferrals for the year under a nonqualified deferred compensation plan be separately reported on a Form 1099 (Miscellaneous Income) or a Form W-2 (Wage and Tax Statement), respectively. The Act requires annual reporting of all compensation deferred under the plan for the year regardless of whether such compensation is includible in gross income pursuant to § 409A(a)(1)(A). However, neither § 6041(g)(1) nor § 6051(a)(13) requires the reporting of deferrals under a nonqualified deferred compensation plan that benefit a person with respect to whom a Form 1099-MISC or a Form W-2 is not required to be filed.

Q-25 What constitutes deferrals for the year under a nonqualified deferred compensation plan for purposes of §§ 6041(g)(1) and 6051(a)(13)?

A-25 Deferrals for the year under a nonqualified deferred compensation plan for purposes of §§ 6041(g)(1) and 6051(a)(13) generally include all deferrals of compensation within the meaning of § 409A that occur during the year and that are made under a nonqualified deferred compensation plan within the meaning of § 409A(d). See Q&A 4 (definition of a deferral of compensation) and Q&A 3 (definition of a nonqualified deferred compensation plan). The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for calculating the amount of deferrals for the year.

Q-26 Do the information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) apply with respect to amounts deferred under a nonqualified deferred compensation plan that is a nonaccount balance plan?

A-26 Yes. The information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) generally apply with respect to amounts deferred under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in § 31.3121(v)(2)-1(c)(2)). However, amounts deferred that are not reasonably ascertainable (as defined in § 31.3121(v)(2)-1(e)(4)) are not required to be reported until such deferrals become reasonably ascertainable (regardless of whether the service provider is an employee). The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for calculating the amount of deferrals for the year under a nonqualified deferred compensation plan.

Q-27 Is there a minimum amount of aggregate deferrals for the year with respect to an individual employee below which the information reporting requirement imposed by § 6051(a)(13) does not apply?

A-27 Yes. The Act authorizes the Secretary of the Treasury, through regulations, to establish a minimum amount of deferrals below which the information reporting requirement imposed by § 6051(a)(13) does not apply. The Treasury Department and the Service anticipate providing the authorized guidance in future regulations. Until such guidance is provided, however, employers may rely on this notice to exclude from the information reporting requirement imposed by § 6051(a)(13) all deferrals for the year with respect to an individual employee under one or more nonqualified deferred compensation plans if the aggregate amount of such deferrals does not exceed $600.

Q-28 What is the effective date for the information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13)?

A-28 The information reporting requirements imposed by §§ 6041(g)(1) and 6051(a)(13) are effective for amounts actually deferred in calendar years beginning after December 31, 2004. Additionally, such information reporting requirements apply to income (whether actual or notional) attributable to amounts actually deferred in calendar years beginning after December 31, 2004. For purposes of §§ 6041(g)(1) and 6051(a)(13), amounts are considered actually deferred at the time the service provider has a legally binding right to the compensation as described in Q&A 4. Thus, the information reporting requirements are not effective for amounts actually deferred in calendar years beginning before January 1, 2005, (or for income attributable to such amounts) notwithstanding that § 885(d) of the Act may treat such amounts as having been deferred in a calendar year beginning on or after such date under the general effective date provisions.

Q-29 How should an employer report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan as required by § 6051(a)(13)?

A-29 An employer should report to an employee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 12 of Form W-2 using code Y. The instructions for Form W-2 provide additional information relating to this reporting requirement. However, see Q&A 38 for interim guidance with respect to an employer's reporting requirements where the employer furnishes an expedited Form W-2 prior to the issuance of additional guidance that will provide a method for calculating the amount of deferrals for the year. Neither § 6051(a)(13) nor this notice affect the rules for reporting deferred compensation in Box 11 of Form W-2.

Q-30 How should a payer report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan as required by § 6041(g)(1)?

A-30 A payer should report to a nonemployee the total amount of deferrals for the year under a nonqualified deferred compensation plan in box 15a of Form 1099-MISC. The instructions for Form 1099-MISC provide additional information relating to this reporting requirement. However, the information reporting requirement imposed by § 6041(g)(1) does not apply to deferrals that are required to be reported under § 6051(a)(13) (without regard to any de minimis exception). Additionally, § 6041(g)(1) does not require the reporting of deferrals under a nonqualified deferred compensation plan that benefit a person with respect to whom a Form 1099-MISC is not required to be filed.

F. Wage Withholding for Employees

Q-31 What wage withholding requirements are imposed by § 885(b) of the Act?

A-31 The Act amends § 3401(a) (defining wages for income tax withholding purposes) to provide that the term “wages” includes any amount includible in gross income of an employee under § 409A. The amount is treated as a payment of wages in the taxable year in which the amount is includible in the employee's gross income. The Treasury Department and the Service anticipate issuing additional guidance that will provide a method for computing the amount includible in gross income of an employee under § 409A.

Q-32 When are amounts that are includible in gross income under § 409A treated as a payment of wages for income tax withholding purposes?

A-32 For the calendar year 2005, amounts includible in gross income under § 409A but neither actually nor constructively received by an employee may be treated as having been paid by an employer for income tax withholding purposes on any date on or before December 31, 2005. However, nothing in § 409A prevents the inclusion of amounts in gross income and in wages for income tax withholding purposes under any other provision or rule of law on a date earlier than December 31, 2005. Thus, amounts includible in gross income under § 409A and either actually or constructively received by an employee during the calendar year 2005 are considered a payment of wages when received by the employee for purposes of withholding, depositing, and reporting the income tax at source on wages.

Q-33 How should an employer report to an employee amounts includible in gross income under § 409A and in wages under § 3401(a) as required by § 6051(a)(3)?

A-33 An employer should report amounts includible in gross income under § 409A and in wages under § 3401(a) in box 1 of Form W-2 as part of the total wages, tips, and other compensation paid to the employee during the year. Additionally, an employer should report such amounts in box 12 of Form W-2 using code Z. The amount reported in box 12 using code Z should include all amounts deferred under the plan for the taxable year and all preceding taxable years that are currently includible in gross income under § 409A and in wages under § 3401(a). The instructions for Form W-2 provide additional information relating to this reporting requirement. However, see Q&A 38 for interim guidance with respect to an employer's reporting requirements relating to an employee or business that is terminated prior to the issuance of additional guidance that will provide a method for calculating the amounts includible in gross income under § 409A and in wages under § 3401(a).

G. Reporting Nonemployee Compensation

Q-34 What reporting requirements relating to nonemployee compensation are imposed by § 885(b) of the Act?

A-34 The Act adds § 6041(g)(2), which requires a payer to report to a nonemployee any amount includible in gross income under § 409A that is not treated as wages under § 3401(a). However, § 6041(g)(2) does not require the reporting of amounts includible in gross income under § 409A that are treated as having been paid to a person with respect to whom a Form 1099-MISC is not required to be filed.

Q-35 How should a payer report to a nonemployee amounts includible in gross income under § 409A and not treated as wages under § 3401(a) as required by § 6041(g)(2)?

A-35 A payer should report the amounts includible in gross income under § 409A and not treated as wages under § 3401(a) in box 7 (nonemployee compensation) of Form 1099-MISC. Additionally, a payer should report such amounts in box 15b of Form 1099-MISC. The amount reported in box 15b should include only the amounts includible in gross income under § 409A and not included in wages under § 3401(a). The instructions for Form 1099-MISC provide additional information relating to this reporting requirement.

Q-36 What are the Seca tax consequences of a failure to satisfy the requirements of § 409A?

A-36 Gross income of a self-employed individual (for example, a nonemployee director, partner, or independent contractor) derived by the individual from any trade or business is generally subject to tax in accordance with the Self-Employment Contributions Act (SECA) when includible in gross income. See §§ 1401, 1402(a). Accordingly, an amount derived from an individual's trade or business that is includible in the self-employed individual's gross income under § 409A is generally subject to the application of SECA taxes at the time such amount is includible in gross income.

Q-37 Does § 885 of the Act affect the imposition of the employee tax and the employer tax under the Federal Insurance Contributions Act (Fica) with respect to wages paid and received for employment under a nonqualified deferred compensation plan within the meaning of § 409A(d)?

A-37 No. Section 885 of the Act does not affect the imposition of the employee tax and the employer tax under FICA with respect to wages paid and received for employment under a nonqualified deferred compensation plan within the meaning of § 409A(d). Thus, remuneration for employment constituting wages within the meaning of § 3121(a) is taken into account for FICA tax purposes in accordance with the rules for wage inclusion under §§ 3121(a) and 3121(v)(2).

- H. Interim Reporting for Expedited Form W-2

Q-38 What are an employer's withholding and reporting obligations where an employee is terminated or a business files a final Form 941 prior to the issuance of further guidance providing methods for calculating the amount of deferrals for the year and the amounts includible in gross income under § 409A and in wages under § 3401(a)?

A-38 An employer is generally required to issue a Form W-2 reporting compensation paid during a calendar year no later than January 31 of the succeeding calendar year. However, if an employee's employment is terminated before the close of the calendar year, an employer must furnish an expedited Form W-2 if requested to do so by the employee. Additionally, an employer may, at its option, furnish a Form W-2 to such an employee at any time after the termination but no later than January 31 of the succeeding calendar year. See § 31.6051-1(d)(i). In addition, if an employer makes a final return on Form 941, the employer must furnish expedited Form W-2s to employees and file expedited Form W-2s with the Social Security Administration. See §§ 31.6051-1(d)(ii), 31.6071(a)-1. If an employer furnishes an expedited Form W-2 before the issuance of additional guidance providing methods for determining the amount of deferrals for the year or the amounts includible in gross income under § 409A and in wages under § 3401(a), the employer need not report an amount described in Q&A-25 (deferrals for the year) or in Q&A-31 (amounts includible in gross income and wages) on the Form W-2. However, if an employer furnishes an expedited Form W-2 prior to the issuance of additional guidance that requires the employer to report a deferral for the year or an amount includible in gross income and wages, then the employer must subsequently furnish a corrected Form W-2. See § 31.6051(c).

IV. Drafting Information

The principal author of this notice is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and, regarding the employment tax and information reporting requirements, Neil D. Shepherd of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the Service participated in its development. For further information regarding this notice, contact Stephen Tackney (202) 927-9639; or for further information regarding the employment tax and information reporting requirements, Neil D. Shepherd (202) 622-6040; or regarding the submission of comments, contact Lanita Van Dyke (202) 622-7180 (not toll-free calls).

# Hot Topics in Employee Benefits Law

**Jeffrey A. Monhart, Esq.**
**Chief, Division of Field Operations, Employee Benefits Security Administration**
**October 17, 2005**

1) Introduction to EBSA
   a) EBSA enforces and administers the Employee Retirement Income Security Act of 1974 (ERISA)
      i) Under ERISA section 504(a), EBSA has broad investigative authority ["the power . . . to determine whether any person has violated or is about to violate any provision of this title . . . ."]
         (1) EBSA has civil and criminal investigative authority
      ii) EBSA conducts enforcement through 15 field offices (10 regional offices and 5 district offices)
      iii) EBSA regulates approximately 700,000 pension plans and 6 million welfare plans
      iv) In Fiscal Year 2004, EBSA closed 4,399 civil investigations, 3,056 of which had corrected violations and EBSA achieved civil monetary results totaling $2.8 billion; EBSA closed 152 criminal cases, obtained indictments of 121 persons, and achieved $5.6 million in monetary results
   b) EBSA's Strategic Enforcement Plan (StEP) guides enforcement of ERISA
      i) The StEP (available on EBSA's Web site (www.dol.gov/ebsa)) provides a framework for allocating enforcement resources to achieve policy and operational objectives, and establishes enforcement priorities
      ii) EBSA leverages its investigative resources by targeting, protecting at-risk populations, and deterring violations
      iii) Under the StEP, EBSA implements its civil enforcement strategy through national investigative priorities, national projects, and regional projects
         (1) National investigative priorities are plan service providers, health benefit issues, and defined contribution plans
         (2) The StEP does not enumerate specific national projects because EBSA may adjust these periodically; however, the current national projects are:
            (a) Health Fraud/Multiple Employer Welfare Arrangements: the emphasis is on fraudulent and abusive MEWAs and other schemes involving mail fraud, wire fraud, bankruptcy fraud, and other ERISA civil and criminal violations
            (b) Orphan Plans: addresses plans abandoned through neglect, bankruptcy, death, or incarceration and either locates a fiduciary to terminate the plan, distribute assets, and file a terminal report or seeks appointment of an independent fiduciary
               (i) The Department proposed three regulations on March 10, 2005 intended to facilitate termination of, and distributions of benefits from, abandoned individual account plans
            (c) Employee Contributions Project: intended to safeguard participant contributions to defined contribution and welfare plans
               (i) In FY 2004, EBSA closed 1,591 ECP civil cases, of which 1,269 had corrected violations, and achieved $31.6 million in monetary results
            (d) Rapid ERISA Action Team (REACT): addresses situations where the plan sponsor faces severe financial hardship or bankruptcy and the assets of a plan are in jeopardy; EBSA ascertains whether plan contributions are unpaid, files or assists in filing proofs of claim, identifies assets of responsible fiduciaries, and oversees distribution of assets
            (e) Employee Stock Ownership Plans (ESOPs): focuses on improper valuations of employer securities, dividends and contributions used to pay exempt loans, allocation of stock to participant accounts, participants' ability to diversify accounts, and loan documentation
         (3) Regional Projects address a type of transaction, industry practice, or emerging concern; examples are:
            (a) Demutualization: such investigations determine whether group welfare plans and retirement plans holding policies with insurance companies that converted from mutual companies to publicly-traded entities

properly shared with plans and participants awards of cash or stock received from the insurers in consideration for their surrender of their membership interest in the mutual insurance company

(b) HIPAA Compliance: these investigations determine whether health plans and associated service providers are complying with Part 7 of Title I of ERISA

(c) Settlor Fees: these cases review the fees and expenses of defined benefit plans to determine whether plan assets have been improperly allocated to the plans for settlor functions (activities which relate to the formation, rather than the management, of plans)

c) Other Enforcement Initiatives

i) Corporate Fraud: EBSA's role is to determine whether fiduciaries responsible for overseeing investments in pension plans should have taken action to safeguard those investments upon knowledge of accounting fraud or misrepresentations

ii) Trading Practices: EBSA is currently conducting a review of practices by mutual funds and other pooled investment vehicles, such as bank collective trusts, as well as service providers and "intermediaries" to such funds, to determine whether there have been any violations of ERISA

(1) EBSA and the Securities and Exchange Commission have published a set of questions (http://www.dol.gov/ebsa/newsroom/fs053105.html) to assist plan fiduciaries in evaluating the objectivity of the recommendations provided, or to be provided, by a pension consultant

d) Voluntary Fiduciary Correction Program

i) Over 1,300 VFCP applications have been received to date, representing over $283 million in corrections

ii) The VFCP is EBSA's self-correction program for 18 transactions that may violate provisions of Title I of ERISA

iii) Eligible applicants (generally, those not under investigation by EBSA or another federal agency regarding a plan) may submit an application that documents correction in accordance with the VFCP's correction guidance and if VFCP conditions are met, receive a no-action letter from the Department and excise tax relief for certain transactions

iv) A final, revised program provides an on-line calculator, model application form, and additional transactions and guidance

## Hot Topics in HIPAA Privacy

*Leslie Reicin Stein, Senior Vice President & General Counsel, Special Data Processing Corp.*
*Kimberly D. Proano, Candidate for JD degree at Stetson University College of Law, May 2006*

I. Background

Before discussing "Hot Topics and Current Trends in Health Care Privacy" as it relates to the Health Insurance Portability and Accountability Act of 1996 (HIPAA)[1], it is necessary to have a general understanding of HIPAA. This Rule protects an individual's personally identifiable medical information from inappropriate disclosure ("Protected Health Information" or "PHI") and grants an individual access to his/her health information. To achieve these objectives, the Secretary of the U.S. Department of Health and Human Services is required to implement a system of national standards and requirements for the electronic transmission of Protected Health Information. Various requirements are listed within the Rule as to the entities subject to the standards ("Covered Entities" or "CE") and the information protected. HIPAA does not replace state protections but it rather supplements them.

A. Covered Entities:

The Privacy Rule sets requirements for Covered Entities that generally have access to an individual's Protected Health Information. The Code of Federal Regulations[2] defines a Covered Entity as either a health plan (such as a health insurance company or a self-insured group health plan); a healthcare clearinghouse; or a healthcare provider who electronically sends health information. Covered Entities are required to provide written notice of their privacy practices and any changes to them; training for their employees; designation of a Privacy Officer; administrative, technical and physical safeguards to protect privacy; and accounting for disclosures of Protected Health Information outside of the Covered Entity.[3]

B. Protected Health Information:

Protected health information under HIPAA includes demographic information created by one of the Covered Entities that pertains to the past, present, or future physical or mental state or condition of an individual or pertains to the provision of health care for such condition or the payment related to such condition.[4] Information, that is not personally identifiable, or reasonably believed to be personally identifiable, is not covered under the HIPAA Regulations. Protected Health Information may be contained in any medium, i.e. oral, written, or electronic.[5] It encompasses information that is created or received by a Covered Entity, including traditional health care records, such as the patient's chart, physician's notes, lab results, hospital records and billing information.[6]

II. Security Regulations

A. General Information

The Security Regulations, effective on April 21, 2003,[7] have been enacted to balance the necessity of electronically accessing personally identifiable health information by those charged with providing and promoting high quality health care with the necessity of protecting an individual's right to privacy.[8] Covered Entities that do not send information electronically are

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[1] Pub. L. No. 104-191, 110 Stat. 1936 (1996). (amending, Employee Retirement Income Security Act of 1974, 29 U.S.C. 1001-1461 (1994). Title II is properly referred to as Administrative Simplification in the Health Care Industry and can be found at http://www.aspe.hhs.gov/admnsimp/. It has two primary areas of regulation: (1) standardization of healthcare transactions and (2) implementation of controls to protect the privacy and ensure the security of an individual's Protected Health Information. The regulations issued by the Department of Health and Human Services creating the national standards became effective on April 14, 2003, and are known collectively as "The Privacy Rule".
[2] 45 C.F.R. § 160.102 (2003).
[3] 45 C.F.R. § 164.528 (2003).
[4] Pub. L. 104-191 § 1171(4)(b) (1996).
[5] Pub. L. 104-191 § 1171(4) (1996).
[6] 45 C.F.R. § 164.514 (2003).
[7] 68 *Fed. Reg.* 8334 (February 20, 2003).
[8] John R. Washlick, *HIPAA Compliance: One Year Later,* Physician's News Digest (August 2004). http://www.physiciansnews.com/law/804washlick.html.

not bound by the Security Regulations. Covered Entities, with the exception of small health plans that cover less than $5,000,000, must comply with the requirements of the Security Regulations by April 21, 2005. Small health plans have until April 20, 2006 to comply.[9]

The government has intended the Security Rule to ensure health information is kept confidential and free from being "altered or destroyed".[10]

B. Safeguards

The three safeguards used to protect such information are physical, technical, and administrative.

1. Physical Safeguards:

The physical safeguards include restricted access to locations and electronic information systems where the Protected Health Information is stored. The physical safeguards ensure that only authorized personnel are able to have access to the electronic information (at the level they are authorized) and protect against tampering and theft. In addition to computer systems, safeguards are required to be in place for workstations, and media containing Protected Health Information as well as for the disposal of these items. Contingency plans for the restoration of data and disaster control must be addressed.[11]

2. Technical Safeguards:

The Security Rule requires a Covered Entity to implement hardware, software and procedural mechanisms to record and examine activity and information systems that contain or use electronic Protected Health Information. Technical safeguards include firewalls to block unauthorized use, unique user identification for tracking, passwords, and monitoring systems. The Rule does not specify the format of passwords or how frequently they must be changed or the length of inactivity time before log-on should automatically terminate. Storage devices on equipment such as CAT Scans and MRIs are covered by the Rule.

The Rule does not provide, with specificity, the level of detail or the capabilities required to exist within the information systems or the mechanisms to corroborate that Protected Health Information has not been altered or destroyed. Each Covered Entity must do a risk assessment and determine the level of audit controls necessary to maintain adequate protection for their Protected Health Information. Each Covered Entity must decide whether or not to implement encryption, decryption or other safeguards. Whether or not the measures adopted by Covered Entities are sufficient will be considered in light of the size of the entity, its technical infrastructure (including its hardware and software capabilities), the cost of implementing specific security measures and the potential risk of harm. As an objective of HIPAA is to have effective electronic information systems that can be easily accessed by those authorized to use the information, the technical safeguards should not be so onerous as to impair this objective.[12]

3. Administrative Procedures:

Administrative procedures encompass risk analysis, risk management, sanctions and information system activity review. A Covered Entity's risk analysis includes "an accurate and thorough assessment of the potential risks and vulnerabilities to the confidentiality, integrity, and availability of electronic protected health information held by the covered entity."[13] A Covered Entity's risk management includes "[i]mplement[ation of] security measures sufficient

[9] Lockton HIPAA Administrative Simplification Legislative Overview attached as Exhibit 1. Special thanks to Lori Sayre of Lockton for their provision of this chart.
[10] Stanley Nachimson, Conference Transcript, *Centers for Medicare and Medicaid Services 19th National HIPAA Implementation Roundtable*, (April 13, 2005). http://www.cms.hhs.gov/hipaa/hipaa2/education/default.asp.
[11] 45 C.F.R. § 164.310 (2003).

[12] 45 C.F.R. § 164.312 (2003), FAQs for Agents of Wisconsin Blue Cross/Blue Shield (undated). Additional information can be found at www.bluecrosswisconsin.com. Also see the Office of Civil Rights Website at www.hhs.gov/ocr/hipaa.
[13] 45 C.F.R. § 164.308(a)(1)(ii)(A) (2003).

to reduce risks and vulnerabilities to a reasonable and appropriate level to comply with §164.306(a)."[14] A Covered Entity's sanction policy includes the "appl[ication of] appropriate sanctions against workforce members who fail to comply with the security policies and procedures of the covered entity."[15] A Covered Entity's information system activity review includes "[i]mplement[ation of] procedures to regularly review records of information system activity, such as audit logs, access reports, and security incident tracking reports."[16]

C. National Provider Identifier

On January 23, 2004, the Secretary of Health and Human Services adopted the National Provider Identifier (the NPI) as the unique health identifier which will identify health care providers in all transactions.[17] The NPI is a 10 digit non-expirable number. Except for small health plans, which must comply by May 23, 2007, all Covered Entities must exclusively use their standard unique health identifiers by May 23, 2007.[18]

D. Difficulties

The New Security Regulations have caused some confusion for Covered Entities in the areas of risk assessment and risk management. As there are not black or white requirements, Covered Entities may not be able to determine if they are in compliance until a number of HIPAA enforcement actions have been reported. It is assumed that Health and Human Services will review compliance, on a case by case basis, taking into consideration the size of an organization and the available budget for implementing safeguards.[19]

The proposed sanctions have also caused some concern due to their lack of consistency. A Covered Entity that commits three thousand violations daily may be assessed the same $100 penalty per day[20] for a violation of HIPAA, as the Covered Entity that commits two infractions daily. While the fine may not be an effective deterrent against future violations for the first entity, it may be for the second.[21]

E. Business Associate Agreements May Need To Be Amended

Business Associates that act on a Covered Entity's behalf must have a written agreement with the Covered Entity that is HIPAA compliant in order to access electronically protected health information. The New Security Regulations now require Business Associates and Covered Entities to include, among other things, the following terms that may not have been included in the original signed Business Associate Agreements:

1. a statement that the Business Associate will implement physical, administrative, and technical safeguards for the protection of the Electronic Protected Health Information (EPHI) it receives from the Covered Entity;

2. a statement that any agent, including subcontractors, that the Business Associate uses will also provide reasonable safeguards to protect the EPHI it receives from the Business Associate; and

[14] 45 C.F.R. § 164.308(a)(1)(ii)(B) (2003).
[15] 45 C.F.R. § 164.308(a)(1)(ii)(C) (2003).
[16] 45 C.F.R. § 164.308(a)(1)(ii)(D) (2003).
[17] 45 C.F.R. § 160.103 (2003).
[18] Kirk J. Nahra, *Privacy Highlights for 2005: Hot Topics to Watch*, Privacy in Focus (newsletter from Wiley Rein & Fielding LLP) (January 2005). http://www.wrf.com/publication.cfm?publication_id=11943.

[19] Washlick, *supra* n. 8. According to *Washlick*, "Enforcement has been and will remain to be event-driven as well as complaint-driven. OCR's [Office of Civil Rights'] enforcement position will continue to be concentrated on education and outreach, except for very egregious situations." But this position could change.
[20] P.L. 104-191 § 1176(a)(1) (1996).
[21] Apfel, Michael, *HHS to Weigh Factors for HIPAA Fines; There's No Clarity in Rule*, Report on Medicare Compliance (April 25, 2005). http://www.aishealth.com/Compliance/Hipaa/RMC_HIPAA_fines.html. In determining the amount of the fine, HHS will look at "the nature of the violation, the circumstances and consequences of the violation, the covered entity's degree of culpability, the history of prior offenses and the covered entity's financial condition." For identical violations, a Covered Entity can be assessed up to $25,000. HHS can count the number of violations by examining the number of times the Covered Entity engaged in the behavior, the number of individuals affected and the number of days the violation occurred.

3. a statement that the Business Associate must report to the Covered Entity any "security incidents" which are any attempted or actual unauthorized interferences relating to the information system.[22]

If the Covered Entity knows, or should have known that a Business Associate is in violation of the Security Rule and fails to take reasonable steps to end the violation, it appears that the Covered Entity will be held to be in violation of the Security Rule.[23]

III. Preemption of State Law

A. Construction

Generally, HIPAA federal privacy protections will preempt state law. State law is generally not preempted by HIPAA when the laws of the state:

(1) impose more stringent privacy requirements for acquiring Protected Health Information,

(2) allow individuals greater access or amendment rights to their own health information,

(3) provide an individual with more information about use, disclosure, rights and remedies with respect to their Protected Health Information, or

(4) provide for a longer retention period or more detailed reporting requirements.[24]

State laws, which among other things, govern public health investigations or the reporting of disease or injury, child abuse, or death, are not preempted.[25] Neither does HIPAA prevent the disclosure of information where there is a serious threat to the health and safety of the public or the individual, provided that the disclosure is made to someone that can reasonably lessen or prevent the threat.[26]

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[22] Washlick, *supra* n. 8. Covered Entities should monitor and audit the practices of their Business Associates to assure that they are and remain in compliance. If Business Associates use subcontractors to perform their work, they must also be in compliance.
[23] *Id.*
[24] 45 C.F.R. § 160.202 (2003).
[25] 45 C.F.R. § 160.201-205 (2003).
[26] 45 C.F.R. § 164.510(a) (2003).

B. Recent Cases Related to Preemption

1. **HIPAA's Provision That It Does Not Preempt More Stringent State Privacy Policies Held Constitutional**

*South Carolina Medical Association v. Thompson.*[27] In this case, the South Carolina Medical Association, Physicians Care Network and several physicians filed suit in order to have several provisions of HIPAA declared unconstitutional. Among other things, they argued that the provision of HIPAA that states that it does not preempt more stringent state privacy laws is unconstitutional. They stated that it is vague and in violation of the Due Process Clause of the Fifth Amendment of the U.S. Constitution "as it calls for subjective judgments on the part of health care providers, who face jail or fines for incorrect determinations."[28] The U.S. Court of Appeals for the Fourth Circuit held that the regulations promulgated by Health and Human Services may require health care providers "to make some common sense evaluations and comparisons between state and federal laws, but this does not mean they are vague or constitutionally infirm."[29]

2. **HIPAA Preempts State Law Related To Who Can Obtain Records**

*Johnson v. Parker Hughes Clinics.*[30] In this case, Mary Johnson requested copies of her late husband's medical and billing records from Parker Hughes Cancer Center for the purpose of investigation and possible suit against this Covered Entity. Parker Hughes denied her request on the ground that she did not comply with HIPAA and that HIPAA preempts Minnesota Law. As HIPAA required that she be appointed under applicable state law as an executor, administrator or other person with authority to act on behalf of her husband's estate to receive

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[27] *South Carolina v. Thompson*, 327 F.3d. 346 (4th Cir. 2003).
[28] *Id.* at 354.
[29] *Id.* at 355.
[30] *Johnson v. Parker Hughes Clinics*, 2005 U.S. Dist. Lexis 741 (D. Minn. 2005).

such information, her request for Protected Health Information was denied.[31] Johnson claimed that she did not have to be appointed as her husband's personal representative, as under Minnesota Statute § 144.335, she was included in the definition of a patient and, therefore, was entitled to the records. Johnson brought an action for relief under the Declaratory Judgment Act[32] as to her rights under HIPAA. The Court held that no subject matter jurisdiction is granted under the Declaratory Judgment Act and that Parker Hughes' defense that HIPAA prevails over state law is inadequate to raise a federal question. The Court further concluded that Johnson could comply with HIPAA by being appointed as her deceased husband's personal representative.

IV. Obtaining Medical Records under HIPAA

A. Notice Requirements

Litigants will often find obstacles in acquiring medical information, necessary to handle their clients' claims, from a health care provider due to concern about HIPAA compliance.

(1) Release by Individual Authorization

HIPAA has implemented stringent requirements for obtaining an individual's authorization to release his/her own medical information. Among other things, a valid authorization must be written in "plain language"[33] and include:

(a) a specific description of the Protected Health Information requested;

(b) the name of the individuals or entity to which the Covered Entity may disclose the information;

(c) a description of the purpose of the disclosure;

[31] *Id.* citing 45 C.F.R. § 164.502(g)(4) (2002).
[32] 28 U.S.C. § 2201-2 (2005).
[33] 45 C.F.R. § 164.508(6)(C)(3) (2003). If the individual is not fluent in English, the authorization must be made in the individual's native language, or if this is not possible an interpreter must read and explain the release in the individual's native language.

(d) an expiration date or event that terminates the right to disclosure;

(e) a statement as to the individual's right to revoke their authorization;

(d) a statement that the information disclosed may be redisclosed and no longer protected; and

(e) a dated signature of the individual, or if of the authorized representative, a description of the representative's authority.[34]

An individual has the right to access and copy his/her own medical records, including Protected Health Information. If such access is denied, such denial must state the reasons therefore and include the process for appeal. A Covered Entity has 30 days from the date of the request to comply or deny.[35]

(2) Permitted Release without Individual Authorization

Protected Health Information may be disclosed by a Covered Entity not only by individual authorization but also by legally reasonable efforts to acquire the individual's authorization and generally permitted uses.

Permitted disclosures under the Privacy Rule that do not require individual authorization include:

(a) treatment of the individual;

(b) payment for services; or

(c) operational requirements of the Covered Entity.[36]

In addition, Protected Health Information may be disclosed by a court order or Qualified Protective Order (QPO). A QPO prohibits the parties from using or disclosing the Protected

[34] 45 C.F.R. § 164.506(c)(1-4) (2003).
[35] 45 C.F.R. § 164.524 (2003).
[36] John F. Olinde, *Understanding HIPAA preemption analysis: who is regulated by the privacy rule and what information does HIPAA protect?*, 72 Intl. Assoc. of Def. Counsels 158 (April 2005).

Health Information for any purpose other than the litigation or administrative proceeding for which such information was requested. It requires the return of the information to the Covered Entity or its destruction (including all copies made) at the end of litigation.[37] Law enforcement officers, when collecting information related to a grand jury subpoena, are allowed to request medical records regardless of the patient's right to privacy where the inquiry is "relevant and material".[38]

A request for "all medical records" may be denied by a Covered Entity on the ground that it is only required to provide records that are the "minimum necessary" to meet the specified purpose of the request. As a consequence, it is good practice to ask the Covered Entity to identify, by category, the records which are being withheld with enough specificity so that further requests can be made by subpoena or otherwise. If the individual has executed a written authorization, the minimum necessary standard does not apply, but the Covered Entity must comply with any restrictions in the authorization.[39]

As the requestor may not know of a specific date for the expiration of the authorization, due to actual or potential litigation, it may be better to select an event such as conclusion of a trial or settlement of all claims or dismissal of the legal action as the expiration date.[40]

B. Copy Services

Copy services are not restricted from imposing high rates for their services. To reduce these costs, counsel should advise the client to request his/her own Protected Health Information.

[37] 45 C.F.R. § 164.512(e)(1)(v) (2003).
[38] 45 C.F.R. § 164. 512(f) (2003).
[39] 45 C.F.R. § 164.502(b); § 164.508(a)(1) (2003).
[40] Craig Tindall, *How to Obtain Medical Records After HIPAA*, Trial 40 (Association of Trial Lawyers of America) June.2004).

The client is only required to pay a reasonable cost based fee of copying, postage and preparing a summary of his/her information.[41] Adverse counsel may acquire Protected Health Information by subpoena thereby taking advantage of statutory restrictions limiting copy services fees.

C. Limitations on Obtaining Protected Health Information by Qualified Protective Order

In *Northwestern Memorial Hospital v. Ashcroft*,[42] the United States District Court for the Northern District of Illinois quashed the Department of Justice's subpoena to order Northwestern Memorial to produce information on forty-five patients of Dr. Hammond. These patients all had late-term abortions. Dr. Hammond was a plaintiff and an expert witness at a trial in the Southern District of New York challenging the constitutionality of the Partial-Birth Abortion Ban Act of 2003.[43] The records were intended to be used by the government to impeach Dr. Hammond's testimony. The government relied upon 45 C.F.R.164.512(e)(1)(ii), which allows a litigant to obtain Protected Health Information if the litigant secures a Qualified Protective Order prohibiting the use of the information outside of the litigation and requiring the information to be destroyed or returned when the litigation is terminated. The District Court quashed the subpoena on the ground that Illinois law is more stringent in the protection of privacy than HIPAA, so Illinois law must be followed. "Under Illinois law, even redacted medical records are not to be disclosed without immaterial exceptions."[44]

The appellate court affirmed the trial court's decision. Its decision was based upon a number of factors including the balancing of the probative value to the government in allowing

[41] 45 C.F.R. § 164.524(c)(4) (2003).
[42] *Northwestern Memorial Hospital v. Ashcroft*, 362 F.3d 923, 924 (7th Cir. 2004).
[43] Pub.L. No.108-105, 117 Stat.1201, 18 U.S.C. § 1531. (1996). The case in the Southern District of New York can be found at National Abortion Federation v. Ashcroft, 2004 U.S.Dist. Lexis 4249, No. 03 Civ.8695 (Rcc), 2004 WL 540470 (S.D.N.Y. Mar.17, 2004). The Act prohibits what is called the D & X procedure in which the fetus is destroyed after the lower extremities and sometimes the torso have been removed from the womb. Dr. Hammond claims to have used this procedure as he believes that there is less danger to the woman in fragile health as there is less risk of hemorrhaging.
[44] *Northwestern Memorial Hospital v. Ashcroft*, 362 F.3d 923, 924 (7th Cir. 2004) at 924.

the disclosure of the information of nonparties against the harm to the patients' privacy. The Court held that even if the information could be redacted so the individuals could not be identified, the disclosure would be an invasion of their privacy and could potentially cause Northwestern Memorial Hospital lack of goodwill. The Court stated that HIPAA creates a procedure to obtain Protected Health Information and does not create privileges such as physician-patient or hospital-patient which are creatures of state law. The Court opined that "in a case such as this in which, so far as we can determine, applying the privilege would not interfere significantly with federal proceedings, comity has required us, not to apply the Illinois privilege, but to consider with special care the arguments for quashing the subpoena on the basis of relative hardship and *Fed.R. Civ. P.* 45(c)."[45] While HIPAA would have allowed such disclosures with redactions, Illinois law would not and, therefore, Illinois law was more stringent and not preempted.

V. *Ex Parte* Communication

Interviewing plaintiff's treating physician *ex parte* by defense attorneys is generally prohibited in 24 states.[46] HIPAA requires an individual to be notified when someone has access to Protected Health Information, whether the information is disclosed in writing or orally.[47] An individual has the right to have an accounting of all disclosures of his/her Protected Health Information for the period six months prior to the request.[48]

Therefore, under HIPAA, an actual or potential *ex parte* communication about the plaintiff's Protected Health Information to a defense attorney by the plaintiff's physician should trigger a notice to the patient and the opportunity to object. Due to the interplay with state law, this is not always the case.

A. Litigated Cases

Two important cases that address preemption of state laws in the area of *ex parte* communications are *Smith v. American Home Products*[49] and *Law v. Zuckerman*.[50]

1. *Smith v. American Home Products*[51]

Defendant drug manufacturers sought a motion to compel plaintiffs' physicians to *ex parte* interviews. The plaintiffs, users of phenylpropanolamine (PPA), claimed that HIPAA preempted New Jersey law[52] and the informal discovery allowed under *Stempler v. Speidell.*[53] They also claimed that defendant's proposed form for the release of Protected Health Information was defective, although it was consistent with *Stempler,* as it did not meet the requirements of HIPAA. The Court held that "HIPAA is an express but selective preemption of New Jersey law."[54] The Court stated that HIPAA does not conflict with New Jersey law or the discovery allowed under *Stempler*. The filing of a suit for personal injury waives some of the plaintiffs' rights to privacy as they have put their medical conditions at issue. For an *ex parte* interview to take place, the Court ruled that "defense counsel must 1) 'provide plaintiff's counsel with reasonable notice of the time and place of the proposed interview'; 2) 'provide the physician with a description of the proposed interview'; and 3) 'communicate with unmistakable

[45] *Id.* at 932-933.
[46] David G. Wirtes, Jr., R. Edwin Lamberth & Joanna Gomez, An Important Consequence of HIPAA: No More Ex Parte Communication Between Defense Attorneys and Plaintiffs' Treating Physicians, 27 Am. J. Tr. Ad. 1 (2003), at 2. Six states permit restricted informal interviews. Three ban such communications by court rule or statute.
[47] 45 C.F.R. § 160.103(1)(iii); 45 C.F.R. § 164.508 (2002).
[48] 45 C.F.R. § 164.528 (2002).
[49] *Smith v. American Home Prod. Corp.*, 855 A.2d 608 (N.J. Super. Ct. 2003).
[50] *Law v. Zuckerman,* 307 F. Supp. 2d 705 (D. Md. 2004).
[51] *Smith v. American Home Prod. Corp.*, 855 A.2d 608 (N.J. Super. Ct. 2003)
[52] N.J. Stat. § 24:84A-22.4.
[53] 495 A.2d 857 (1985).
[54] *Smith v. American Home Prod. Corp.*, 855 A.2d 608, 610 (N.J. Super. Ct. 2003).

clarity the fact that the physician's participation . . . is voluntary'."[55] The Court declined to rule that HIPAA preempted state law with regard to *ex parte* interviews but imposed HIPAA-like compliance restrictions to authorizations for the release of Protected Health Information.

2. *Law v. Zuckerman*[56]

The issue in this medical malpractice case was whether the defendant's counsel's *ex parte* communications with the Plaintiff's treating physician violates HIPAA and if so, what should the remedy be? In contacting the physician, the defendant relied upon Maryland law which does not prohibit pretrial *ex parte* communications with physicians. The Court held that while HIPAA does not prohibit *ex parte* communications, it clearly regulates the method by which Protected Health Information can be released and therefore preempts Maryland law. "HIPAA regulations permit discovery of protected health information so long as a court order or agreement of the parties prohibits disclosure of the information outside of litigation and requires the return once proceedings are concluded".[57] Hence, informal discovery without patient knowledge and consent is prohibited. According to this Court, the key component in determining whether Maryland law or HIPAA prevails is the conclusion as to which law affords the individual the greater control over the release of Protected Health Information.[58]

Although the Court found a violation of HIPAA, as the defendant's counsel had a good faith belief that he was complying with Maryland law and appeared to be unaware of the overlay of the HIPAA procedures for disclosure, sanctions were deemed to be inappropriate.

B. Dilemma for Physicians and other Covered Entities

HIPAA requires physicians and Covered Entities to provide only the minimum necessary information in response to a lawful request for Protected Health Information. Both failure to provide information and provision of information may lead to sanctions and criminal or civil liability and costly attorney's fees.[59] Physicians are placed in an untenable position when they have to respond to *ex parte* inquiries by adverse counsel as they owe a duty to their patients to protect their confidences. Patients rely on the physician-patient privilege in informing physicians of information needed to provide treatment.[60] Releasing this information *ex parte* may have a dampening effect upon patients receiving treatment.

While HIPAA does not create a federal physician-patient privilege or a private right of action, it has an administrative complaint procedure and the Secretary of Health and Human Services can pursue rights or remedies for individuals who are aggrieved by HIPAA violations.[61]

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[55] *Id.* at 612 citing *Stempler v. Speidell*, 495 A.2d 857 (1985). Some courts have required a more extensive list. e.g.: In *Keshecki v. St. Vincent's Med. Ctr., 5 Misc.3d* 539 (2004), *at 544-45*, the court held that in order to comply with the federal HIPAA privacy rules a defendant's counsel who wishes to interview a plaintiff's patient's treating health care provider must comply with the following provisions:

"1. Defense counsel must obtain an authorization separate and apart from any other authorization;
2. The authorization on its face should state in bold letters that the purpose of the disclosure is *not* at the request of (the plaintiff) patient;
3. The purpose should be stated in bold print, "The purpose of the information is to assist the defendant in defense of a lawsuit brought by the plaintiff";
4. The authorization must contain the name and business address of the person to whom the health care provider or hospital employee may give an interview and identify the persons or entities the interviewer is representing *45 C.F.R. 164.508[c][1][iii]*);
5. The authorization must conform to all of the core elements and requirements of *45 C.F.R.§ 164.508(c)*; and
6. There shall be a separate authorization for each interview and the authorization shall not be combined with a subpoena, which only acts to intimidate the doctor.

Within five days after the interview, whether in person or on the telephone or by any other manner which technology allows, the defendant must provide the plaintiff with

1. Any and all written statements, materials or notations and any document obtained from the interviewed health care provider; and
2. Copies of any memoranda, notes, audio or video recording, which records any oral or written statements made of the health care provider.

The defendant's counsel need not disclose their observations, conclusions, impressions or analysis of any of the statements."

[56] *Law v. Zuckerman*, 307 F. Supp. 2d 705 (D. Md. 2004).

[57] *Id.* at 708.

[58] *Id*. at 710. *Law* relied on *United States ex rel. Stewart v. La. Clinic*, 2002 U.S. Dist.LEXIS 24062, 2002 WL 31819130 (E.D. La. 2002) and *In re PPS Litigation*, 2003 WL 22203734 (N.J) Super. L. (2003) in deciding this case.

[59] Wirtes, *supra*, n.46 at 7. The Office of Civil Rights may impose civil fines of up to $100 per violation ($25,000 maximum per year). Criminal penalties can be assessed up to $250,000 and ten years in prison. Covered Entities may also be sued under state law for breaches of fiduciary duty or confidentiality.

[60] *Id.* at 10-11.

[61] *Holzle v. Healthcare Services Group, Inc*, 2005 NY Slip OP 50770U: 2005 N. Y. Misc. LEXIS 1031 (2005).

Failure to object or comply with the production of Protected Health Information in connection with a subpoena may result in the Covered Entity being held in contempt of court.[62]

C. Dilemma for Attorneys

Before granting access *ex parte* to Protected Health Information, Covered Entities may require assurance that attorneys have used reasonable efforts to ensure that the subjects of inquiries have been given notice of the requests. Unless attorneys obtain written authorizations signed by the plaintiff, which comply with HIPAA and permit *ex parte* oral communications, or Qualified Protected Orders, some Covered Entities may refuse to comply. For those Covered Entities that are willing to accept "reasonable assurances" in connection with a subpoena, discovery request or other lawful process, not accompanied by a court or administrative order, the attorney seeking the information may be required to provide to the Covered Entity a written statement containing assurances that the party seeking the information has made reasonable efforts to notify the person whose Protected Health Information is sought and that no timely objection has been filed.[63] Some courts require attorneys to ensure the information is properly used and returned or destroyed at the conclusion of the litigation. This requirement is impractical and onerous as the attorney cannot guarantee against the misuse of Protected Health Information by third parties.[64]

C. The Law Is Still Unsettled As To E*x Parte* Communications

There are two schools of thought. The first is that since HIPAA preempts state law where state law is less stringent, and HIPAA requires certain disclosures before defense counsel can converse with the plaintiff's physicians, there should be no *ex parte* communications without the plaintiff's consent.[65] The second is that since plaintiffs put their medical conditions at issue in litigation, they waive the privacy protections under HIPAA and therefore have consented to *ex parte* communications.[66]

Due to differing state laws, practices and court rules, there are varying interpretations of what information can be obtained during *ex parte* interviews and what affect HIPAA has upon these practices. The New York Supreme Court, in *Holzle*[67] examined cases from eight different justices in seven different counties in the state of New York, to demonstrate the inconsistencies in the authorizations required for defense counsel to conduct *ex parte* interviews. While some courts required plaintiffs to execute authorizations and disclose documents and statements arising from the interviews to opposing counsel, others did not. The New York Supreme Court, in line with the second school of thought, held that plaintiffs waive their substantive rights and remedies under HIPAA, as well as the physician-patient privilege, once they assert their mental or physical condition in the litigation. Therefore, this Court held that *ex parte* communications are permitted without plaintiff authorization.[68]

VI. Sanctions

Although the Office for Civil Rights of the Centers for Medicare and Medicaid Services has the power to impose civil penalties against Covered Entities that violate any of the HIPAA regulations, it has not strictly enforced sanctions against defense counsels' misuse of *ex parte* communications.[69]

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[62] John D. Buchanan Jr., *Subpoenas DucesTecum vs. HIPAA: which wins?*, 79 Fla. Bar J. 39 (6) (Feb. 2005).
[63] *Holzle v. Healthcare Services Group, Inc*, 2005 NY Slip OP 50770U: 2005 N. Y. Misc. LEXIS 1031 (2005) citing 45 C.F.R. § 164.512(e) (2002).
[64] Buchanan, *supra* n. 62 at 8-9. As expert witnesses, court reporters, etc. have copies of the Protected Health Information, the attorney cannot assure that it will not be improperly disclosed. In addition, Protected Health Information is disclosed at public trials and may be made available in the jury room.
[65] Bobby Russ. *Can We Talk? The Rest of the Story Why Defense Attorneys Should Not Talk to Plaintiff's Doctors*, 39 Tenn B.J. 29 (February 2003); Marie Pollio, The Inadequacy of HIPAA's Privacy Rule: *The Plain Language Notice of Privacy Practices and Patient Understanding*, 60 N.Y.U. Ann.. Sur. Am. .L 579.
[66] Buchanan, *supra* n.62 at 10.
[67] *Holzle v. Healthcare Services Group, Inc*, 2005 NY Slip OP 50770U: 2005 N. Y. Misc. LEXIS 1031 (2005).
[68] *Id.*
[69] *Washlick*, supra n.8 at 1-2.

Sanctions were imposed in *Crenshaw v. Mony Life Insurance Co.*[70] by the United States District Court for the Southern District of California. Defense counsel was held to be in violation of HIPAA compliance with regard to *ex parte contacts* with plaintiff's consulting physician as the information was not disclosed pursuant to a court order, subpoena or discovery request.[71] Because the contact was not with plaintiff's treating physician, it was permissible under Section 996 of the California Evidence Code.[72] Plaintiff moved to remove defendant's attorney and to disqualify plaintiff's consulting physician as an expert witness.[73] As HIPAA does not provide guidance with regard to how to treat violations that occur during discovery or trial, the court fashioned an appropriate remedy which did not include disqualifying defense counsel or barring the expert from testifying.[74]

HIPAA violations can occur either willfully or negligently. In determining the severity of sanctions, the nature of the violations, the degree of culpability, and financial condition of the Covered Entity should be considered.

A. Criminal Violations

HIPAA has a schedule of penalties for "Wrongful Disclosure Of Individually Identifiable Health Information"[75] which applies to persons, not just Covered Entities. The prohibited disclosures are improper use of unique health identifiers, improper obtaining of Protected Health Information and improper disclosure of Protected Health Information.[76] For violations that are knowing, a person can "be fined not more than $50,000 [and/or] imprisoned not more than one year, or both."[77] For violations committed under false pretenses, a person can "be fined not more than $100,000 [and/or], imprisoned not more than five years or both".[78] For violations "committed with intent to sell, transfer, or use individually identifiable information for commercial advantage, personal gain, or malicious harm, [a person can] be fined not more than $250,000 [and/or] imprisoned not more than 10 years or both".[79]

In 2004, the first criminal conviction under HIPAA for wrongful disclosure of individually identifiable health information or identity theft occurred. Gibson, a hospital employee used a cancer patient's name, date of birth and social security number to acquire four credit cards in the patient's name, and incurred a debt of $9,000. By plea agreement, Gibson agreed to a term of 10 to 16 months, which could be served in federal prison or combination of federal prison and either home or community confinement, dependant on the Court's order. Gibson also agreed to pay restitution to the victim and the credit card companies.[80]

B. Civil Violations

Failure to comply with the HIPAA requirements and standards can result in a penalty of not more than $100 per violation, except that the total amount imposed on the person for all violations of an identical requirement or prohibition during a calendar year may not exceed $25,000.[81] Civil remedies may not be imposed if (1) the violator did not know and by exercising reasonable diligence would not have known of the violation, or (2) failure to comply was due to

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[70] 318 F. Supp. 2d 1015 (S.D. Cal. 2004).
[71] *Id.* at 1029.
[72] *Id.* at 1022. Under the California Codes of Ethics, defense counsel is not required to notify plaintiff's counsel before contacting plaintiff's consulting physician. By placing his medical condition at issue, the Court held that the plaintiff waived the patient-physician privilege with respect to the medical condition, tinnitus, and the determination of whether it renders him disabled, which was the subject of this proceeding. *Id*. at 1026-1027.
[73] *Id.* at 1018.
[74] The physician was not disqualified as he only had one contact with the plaintiff, which did not involve treatment. The Court admonished attorneys that "contacts with healthcare providers are fraught with danger". If the physician had numerous contacts with the plaintiff or monitored his condition, the opinion could have been different. As the attorney does not know the physician's relationship with the plaintiff before the ex parte contact, this is not a recommended practice. *Id*. at 1027. The remedy was to assess expert witness fees, court reporter fees and the consulting physician's attorney's fees against the defendant. *Id*. at 1030.
[75] P.L. 104-191 § 1177 (1996).
[76] P.L. 104-191 § 1177(a) (1996).
[77] P.L. 104-191 § 1177(b)(1) (1996).
[78] P.L. 104-191 § 1177(b)(2) (1996).
[79] P.L. 104-191 § 1177(b)(3) (1996).
[80] U.S. Dist. Attorney's Office for Wtrn Dist. of Wash., *Seattle Man Pleads Guilt in First Ever Conviction For HIPAA Rules Violation*, http://www.usdoj.gov/usao/waw/press_room/2004/aug/gibson.htm (last updated August 19, 2004).
[81] P.L. 104-191 § 1176(a) (1996).

reasonable cause and not willful neglect and such failure is corrected within 30 days from the first date the person liable for the violation knew or would have known of the violation.[82] As guidance with respect to discovery and trial violations is not found in HIPAA, courts have used their discretion to fashion appropriate remedies.[83]

Individuals are not only concerned with identify theft, but they also fear discrimination if sensitive Protected Health Information is disclosed to employers and others. While HIPAA does not provide a private cause of action for breach of confidentiality, individuals are not preempted from suing under state privacy laws, unfair trade practice laws, or tort laws.[84]

VII. Conclusion

Much will be learned with respect to the interpretation of HIPAA and its requirements during the next year. Hopefully, there will be greater clarity and that enforcement activities will still be primarily directed towards the education of Covered Entities and Business Associates. The interplay between HIPAA and state laws and litigation practices will continue to be challenging.

[82] 42 U.S.C.A. § 1320-d5 (1996).
[83] *Crenshaw v. Mony Life Insurance Co*., 318 F. Supp. 2d 1015 (S.D. Cal. 2004); *See*. n.72.
[84] Wirtes, supra n. 46 at 8.

Exhibit 1 Lockton HIPAA Compliance Services
HIPAA Administrative Simplification Legislative Overview

President Clinton signed the Health Insurance Portability and Accountability Act (HIPAA) into law in August 1996. The first component requiring compliance was Title I—Portability. This portability legislation governs provisions related to pre-existing conditions, guaranteeing issuance of group coverage to small employers, and prohibiting discrimination by a health plan based on the individual's health status.

The HIPAA legislation also included provisions which required that regulations be passed which:

- Set forth uniform standards for the electronic transmission of health care data
- Insure privacy of individually identifiable health information, also called protected health information
- Provide individuals with certain rights related to their health information
- Insure appropriate security practices are enacted to protect the health information of individuals

The regulations to achieve the above provisions are collectively known as HIPAA's Administrative Simplification (Title II) legislation. The regulations identify specific requirements for protecting an individual's health information through privacy, security and electronic transactions and code sets requirements. These standards apply to health plans, health care providers and health care clearinghouses.

Administrative Simplification regulations have been released in different components, each with varying effective dates. For health plans, effective dates vary based on the group health plan's size; plans with revenue of less than $5 million in annual premiums or claims are considered small health plans and were given additional time to comply with the regulations. A summary of regulation effective dates follows:

Table 1. . .HIPAA Administrative Simplification Effective Dates

| | **Small Health Plans (less than $5 million)** | **Health Plans ($5 million or above)** | **Health Care Providers & Health Care Clearinghouses** |
|---|---|---|---|
| Transactions and Code Sets | October 16, 2003 | Original Effective Date: October 16, 2002<br>Revised Effective Date: October 16, 2003<br>*(to qualify for revised date, extension request filings were due October 15, 2002)* | |
| Privacy | April 14, 2004 | April 14, 2003 | April 14, 2003 |
| Security | April 20, 2006 | April 20, 2005 | April 20, 2005 |
| Employer Identifier | June 30, 2004 | June 30, 2004 | June 30, 2004 |
| Provider Identifier | May 23, 2008 | May 23, 2007 | May 23, 2007 |
| Payer Identifier | Regulation not yet final—effective date to be determined | | |
| Individual Identifier | Regulation not yet final—effective date to be determined | | |

As an employer who offers group health plan benefits to its employees, you may have HIPAA compliance requirements. Group health plans include both insured and self-insured plans that pay for the cost of medical care. These may include flexible spending accounts, medical plans, dental plans, or other medical service plans such as optical, prescription drug and behavioral health. If your organization offers health clinic services and bills for these services, you may also have HIPAA compliance obligations as a health care provider.

HIPAA legislation established civil monetary penalties and criminal penalties. Penalties for non-compliance range from $100 per violation (capped at $25,000 per year per standard violation) for simple non-compliance to $250,000 and a 10-year prison term for obtaining protected health information for commercial or malicious purposes. All enforcement activities will be the responsibility of the United States Government; a table showing enforcement divisions follows.

**Table 2. . .HIPAA Administrative Simplification Enforcement Agencies**

| | Civil Monetary Penalties (CMPs) | Criminal Penalties |
|---|---|---|
| Transactions and Code Sets | Centers for Medicare and Medicaid Services (CMS) | U.S. Department of Justice |
| Privacy | Office of Civil Rights (OCR) | |
| Security | Centers for Medicare and Medicaid Services (CMS) | |
| Identifiers | Centers for Medicare and Medicaid Services (CMS) | |

*Note: CMS and OCR are division of the United States Department of Health and Human Services.*