

**The New Nonqualified Deferred Compensation  
Provisions Under Code Section 409A  
- Updated to include Proposed Regulations -**

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## **TABLE OF CONTENTS**

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	<b>Page</b>
<b>I. Introduction .....</b>	<b>1</b>
<b>II. Definition of Nonqualified Deferred Compensation .....</b>	<b>2</b>
<b>III. Taxation Rule .....</b>	<b>4</b>
<b>IV. Election Requirements .....</b>	<b>5</b>
<b>V. Distributions Requirements .....</b>	<b>6</b>
<b>VI. Distribution upon Change in Ownership or Control .....</b>	<b>7</b>
<b>VII. Distribution upon Unforeseeable Emergency .....</b>	<b>8</b>
<b>VIII. Distribution upon Disability .....</b>	<b>9</b>
<b>IX. Accelerated Non-Hardship Distributions .....</b>	<b>9</b>
<b>X. Change in Time or Form of Distribution .....</b>	<b>9</b>
<b>XI. Funding .....</b>	<b>11</b>
<b>XII Annual Reporting .....</b>	<b>11</b>
<b>XIII. Penalties for Noncompliance .....</b>	<b>12</b>
<b>XIV. Grandfather and Transition Rules .....</b>	<b>12</b>
<b>XV. Recommended Course of Action by the end of 2005 .....</b>	<b>14</b>

## **I. Introduction**

On October 11, 2004, the Senate gave final approval to the American Jobs Creation Act of 2004 (the "Act"). The House had passed the Act on October 7, 2004 and the President signed it into law on October 22, 2004. As part of the Act, the Treasury was required to issue guidance by December 21, 2004 to provide a limited time during which nonqualified plans adopted before December 31, 2004 may be amended without violating the new rules. On December 20, 2004, the IRS issued Notice 2005-1 that provided the first in a series of such guidance. The IRS released the second round of guidance on September 29, 2005 in the form of proposed regulations under Code Section 409A.

The following is an explanation of the nonqualified deferred compensation provisions of the Act, the clarifications provided by the IRS in Notice 2005-1 and the further detailed operational rules relating to elections and distributions, as well as plan terminations under the proposed regulations.

The following compares the major provisions of the Act with the law in effect before 2005. With this comparison, the impact of the changes under the Act can be better understood. The Act significantly changes the tax treatment of nonqualified deferred compensation plans by adding Section 409A to the Internal Revenue Code.

The Act generally affects compensation deferred after December 31, 2004. However, the Act also affects amounts deferred under a plan that is "materially modified" after October 3, 2004.

In Notice 2005-1, the IRS provides the following guidance in regard to applying the effective date of Code Section 409A:

An amount is considered deferred as of December 31, 2004 if:

- the employee has a legal binding right to be paid the amount, and
- the right to the amount is earned and vested.

A material modification will occur if:

- a benefit or right as of October 3, 2004 has been enhanced or a new benefit or right has been added (even if permitted under Code Section 409A); or
- the vested December 31, 2004 amount has been accelerated.

In the proposed regulations, the IRS provides guidance for:

- transitional steps for bringing plans into compliance,
- grandfather rules for amounts deferred before 2005,

- exceptions for certain payments from being subject to the rules,
- clarifications in which amounts are considered deferred compensation,
- treatment of stock appreciation rights,
- advance elections for the amount for deferral and the time and form of payment,
- permissive payout triggers,
- accelerations and re-deferrals, and
- extensions for amending plans until December 31, 2006.

But, in the proposed regulations, the IRS has failed to provide guidance for:

- Penalty provisions for non-complying taxpayers,
- Form W-2 and 1099 reporting,
- Offshore funding arrangements, and
- Funding triggers tied to a downturn in the employer's financial condition and arrangements between partnerships and partner.

## **II. Definition of Nonqualified Deferred Compensation**

**Law Before 2005** - Any plan or arrangement for deferral of compensation that was not tax-qualified under the Code.

**Code Section 409A** - Any plan, agreement or arrangement that provides for the deferral of compensation other than a "qualified retirement plan"; or any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan.

**Notice 2005-1** - The IRS clarifies that the definition includes any elective compensation deferral arrangements and other compensation arrangements. This includes any elective deferral of annual bonuses, SERPs, excess benefit plans, severance arrangements, phantom stock, deferred stock, certain stock appreciation rights, certain transfers of partnership interests and 457(f) plans. The IRS also excluded from the definition certain multi-year compensation arrangements, fiscal year bonuses, HRAs, HSAs, flexible spending accounts, restrictive stock programs and routine business payments.

**Proposed Regulations** - The proposed regulations provide the following clarifications:

**Short-term deferrals** - Any payment of compensation made within 2-1/2 months following the close of the year in which there is no longer a recognized substantial risk of forfeiture will not be considered a deferral of compensation. If an employee decides to defer payment beyond the end of the 2-1/2 month period, the requirements of Code Section 409A will apply.

**Severance programs** - These programs, called separation pay arrangements under the proposed regulations, are covered by Code Section 409A, but the IRS provides several important exceptions. Some programs may qualify for the short-term exception, discussed immediately above. Other programs may be exempt if the amount is paid upon an actual involuntary separation from service or under a window program lasting up to one year. If the program is not collectively bargained, two additional conditions apply: (1) amount paid cannot exceed two times the lesser of (a) the individual's annual compensation or (b) the Code Section 401(a)(17) limit for qualified plans, (\$210,000 for 2005) and (2) all payments must be completed by the end of the second calendar year following the year of separation.

If the program is not exempt and offers payment options, the initial deferral election may be made at any time before the employee obtains a legal binding right to payment. If the amount is payable under a window program the initial deferral election may be made at any time before participation in the program becomes irrevocable.

**Reimbursement arrangements** - If an employer reimburses an employee for expenses, these payments may be subject to Code Section 409A, unless the reimbursements are made in relation to employee terminations. Reimbursements made for outplacement fees, moving, medical expenses and in-kind benefits (office space or clerical help) before the end of the second calendar year after separation will be exempt. In addition, reimbursements made after the two year will be exempt if they do not exceed \$5,000.

**Split-dollar life insurance** - Arrangements that provide death only benefits and those taxed under the loan regime are not subject to Code Section 409A. The following arrangements would be subject to Code Section 409A: (1) employer forgives an executive's indebtedness, (2) an employer continues to pay premiums at below-market interest rates, (3) an employer owns a life insurance policy and agrees either to transfer it to an executive in the future or to pay future premiums.

**Equity compensation** - Non-discounted stock options and restricted awards are generally exempt from Code Section 409A if they have no other features providing for a deferral of compensation.

Non-discounted SARs will be treated like non-discounted stock options, even if they are settled in cash and even if they are based on stock that is not publicly traded.

**Written Plan Requirement** - IRS provides that any deferred compensation arrangement must be established in accordance with Code Section 409A. A plan is established if its material terms are set forth in writing, including the amount deferred and the time payment is made. Code section will be violated if the plan is not adopted and set forth in writing by 2-1/2 months after the year in which the legal binding right to the compensation arises (or, for compensation payable in the year following the year the legally binding right arises, if it is not adopted and in writing by the end of the year in which the legally binding arises). For any arrangement adopted and effective before December 31, 2006, it does not have to be in writing until December 31, 2006.

### **III. Taxation Rule**

**Law Before 2005** - Deferred amounts generally were not currently includible in income if any of the taxation rules did not apply. These rules included the constructive receipt doctrine under Code Section 61, the economic benefit doctrine under Code Section 61, the property rule under Code Section 83 and the "vested accrued benefit" rule under Code Section 402.

**Code Section 409A** - All deferred amounts are currently includible in income (and subject to interest and an additional tax, as discussed below) to the extent not subject to a "substantial risk of forfeiture" UNLESS the plan satisfies particular requirements regarding distributions, acceleration of benefits and deferral elections under Code Section 409A.

**Notice 2005-1** - Code Section 409A applies in addition to preexisting rules of taxation, including constructive receipt, economic benefit, cash equivalency and Code Section 457(f). Compensation is taxed at the earlier of the time that applies under any of these principles and the time that applies under Code Section 409A.

Compensation is subject to a substantial risk of forfeiture if (a) it is conditioned on substantial services or on the occurrence of a condition related to compensation and (b) the possibility of forfeiture is substantial. Refraining from substantial services, e.g. a non-compete agreement is never a substantial risk for forfeiture under Code Section 409A, even though it can be in some cases under Code Sections 83 and 457.

Elective extensions or additions of substantial risks of forfeitures are disregarded for purposes of Code Section 409A.

**Proposed regulations** - IRS provided that neither a “rolling risk of forfeiture” under which the employer periodically agrees to extend the risk of forfeiture, nor non-competition conditions are considered substantial risk of forfeiture.

#### **IV. Election Requirements**

**Law Before 2005** - Deferral elections generally must be made before any compensation is earned.

**Code Section 409A** - Deferral elections must be made prior to the beginning of the taxable year in which the compensation is earned. Newly eligible participants must make elections with respect to service performed subsequent to the election within 30 days after becoming eligible to participate.

A significant exception to this general rule applies to performance-based compensation of services over a period of at least 12 months. In this case, the deferral election must be in place 6 months before the end of the service period.

**Notice 2005-1** - It provides a temporary definition of performance-based compensation until further guidance is released. Performance-based compensation requires that the performance period be at least 12 months, the performance contingency must be based on individual or organizational criteria that are not substantially certain at the time of the deferral election. Subjective criteria are permitted if they relate to the participant or a work group or organization to which the participant belongs.

**Proposed Regulations** - The proposed regulations provide the following clarifications:

**Newly eligible participants** - The 30 day period for newly eligible participants only applies if the participant does not already participate in other deferred compensation plans of the same type.

**Mid-year grants** - If deferred compensation awards are made mid-year, prior year elections are not required if the award is subject to a risk for forfeiture requiring continued performance of services for a period of at least 12 months. In such cases, the initial deferral election may be made within 30 days after the grant date, provided that the election is also made at least 12 months in advance of the end of the service period.

**Performance-based compensation** - The criteria for performance-based compensation must now be established in writing no later than 90 days after the performance period begins and that compensation can be performance-based if it is based solely on an increase in the value of the employing organization or employer stock after the date of grant. However, equity based compensation

that is not solely based on an increase in the value of recipient stock will qualify as performance-based if it is subject to a condition that would cause the award to otherwise qualify as performance based.

**Fiscal year compensation** - The initial election to defer fiscal year compensation may be made on or before the end of the fiscal year immediately preceding the first fiscal year in which any services are performed for which the compensation is paid. To qualify as fiscal year compensation for this purpose, the compensation must specifically be based on the service recipient's fiscal year as the measurement period. This rule is available for bonuses determined on a fiscal year, but not for salary.

**Commissions** - A service provider is treated as having performed the services giving rise to payment that qualify as "commissions" during the year in which the customer makes payment for related goods and services

## **V. Distributions Requirements**

**Law Before 2005** - No restrictions applied other than constructive receipt.

**Code Section 409A** - A deferred compensation plan may allow distributions only upon:

- A separation from service (6 months after separation from service for "key employees" of public corporations);
- Death;
- A specified time (or pursuant to a fixed schedule) specified under the plan;
- A change in ownership or control (to the extent provided by the IRS);
- An unforeseeable emergency; and
- Disability.

**Proposed Regulations** - The proposed regulations provide the following clarifications:

### **Payment triggers:**

- The term "fixed date" for distribution purposes will be interpreted broadly allowing certain event linked payout, where vesting is triggered by the occurrence of the event.

- Payments may be made upon the earlier or later of two or more permissible events or times. A different form of payment may be elected for each potential payment event. The re-deferral and acceleration rules apply separately to each payment event.
- Once the event occurs the payment can be made at any objectively determinable time designated by the plan. If desired, a plan may specify simply the calendar year in which payments will be made without specifying the particular date within the year. A payment will be treated as timely if made by the end of the calendar year containing the designated time. Further delays are permitted if payment is not administratively feasible because of events beyond the employee's control.

**Multiple Payment Events** - A plan may provide for payment at the earlier of, or later of two or more permissible events or times, and a different form of payment may be elected for each potential payment event

**Separation from Service** - An employee is treated as incurring a separation of service when he or she dies, retires or otherwise has a termination of service. The employment relationship continues during a bona fide leave of absence that does not exceed 6 months or longer if the right to reemployment is protected by statute or contract. For independent contractors, the definition of severance from employment is based on the definition of severance from employment, as provided under the regulations for Code Section 457.

All facts and circumstances will be considered in determining whether a termination of employment as occurred. If the employee and employer only intend for the employee to provide insignificant services, employment will not be considered continued. Under a safe harbor, if the annual level of services and pay are least 20% of the average prior levels, significant services are considered to be intended. If an employee switches to consultant status, employment will be deemed to continue if annual pay and services are at least 50% of prior levels.

## **VI. Distribution upon Change in Ownership or Control**

**Law Before 2005** - Employers generally had broad discretion to define "change in ownership or control."

**Code Section 409A** - Statute provides that the term will be defined by the IRS.

**Notice 2005-1** - IRS provides a three-part definition to "change in control":

- a change in control of the employer (or of the employer's parent or any corporation higher in the chain, or of the corporation which is ultimately liable for the deferred compensation payment);

- a change in effective ownership of the employer (or other corporation as above); or
- a change in ownership of substantial assets of the employer (or other corporation as above).

A “change in ownership” generally occurs when a person (or group of people pursuant to a merger or similar transaction) acquires more than 50% of the total fair market value or total voting power of employer’s stock.

A “change in effective ownership” generally occurs when (1) a person (or group of people as above) acquires (or has acquired during a 12-month period) 35% or more of the total voting power of the employer’s stock or (2) 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 preexisting board of directors.

A “change in ownership of substantial assets” generally occurs when a person (or group of people as above) acquires (or has acquired during the preceding 12-month period) assets totaling more than 40% of the gross fair market value of all the employer’s assets. The acquiring person (or group) can not be related to the target corporation.

In addition, an employer may exercise discretion under the terms of the plan to terminate the plan after a change in control and distribute the entire plan benefit within 12 months of the change in control.

**Proposed Regulations** - IRS indicates that it will issue regulations extending these rules to partnerships and that until such regulations are issued, the existing rules for corporations may be applied to partnerships.

## **VII. Distribution upon Unforeseeable Emergency**

**Law Before 2005** - Generally, a plan could provide for the payment of benefits in the case of an unforeseeable emergency that was caused by an event beyond the control of the participant (to the extent it did not amount to constructive receipt).

**Code Section 409A** - The term “unforeseeable emergency” is defined as a severe financial hardship resulting from (i) a sudden and unexpected illness or accident of the participant or beneficiary, their spouse, or dependent; (ii) a loss of the participant’s property due to casualty; or (iii) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

**Proposed Regulations** – IRS provides examples of situations that qualify as unforeseeable emergencies. They include property damage resulting from a natural disaster, imminent foreclosure of or eviction from primary residence, payment of medical and funeral expenses. Payment of college tuition and purchase of a home are not considered unforeseeable emergency. Emergencies that can be relieved from other sources do not qualify. A plan need not make distributions for all emergencies specified in the regulations, as long as all emergencies that trigger distributions meet the requirements of Code section 409A.

## **VIII. Distribution upon Disability**

**Law Before 2005** - Employers had broad discretion to define "disability."

**Code Section 409A** - A participant is considered disabled if he/she is (i) 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 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 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.

**Proposed Regulations** - An employer may define disability in its plan document with deference to Social Security Administration disability determinations. A plan document does not need to provide for payment upon all events that would qualify as disabilities.

## **IX. Accelerated Non-Hardship Distributions**

**Law Before 2005** - So-called "haircut" provisions were permitted. Participants could agree to take a lesser amount at any time rather than wait until the agreed-upon payment date.

**Code Section 409A** - Acceleration of the time or schedule for paying any benefits are not allowed, except as provided by the IRS in regulations.

**Notice 2005-1** - IRS clarifies that accelerated vesting that does not itself trigger a distribution (and that otherwise meets Code Section 409A) is permissible, even though it makes it possible a distribution that otherwise would not occur.

## **X. Change in Time or Form of Distribution**

**Law Before 2005** - Plans may permit a participant to change their elections regarding the timing or form of distribution so long as there was no constructive receipt.

**Code Section 409A** - Elections to delay the timing or change the form of payment ONLY if:

- the election does not take effect until at least 12 months following the date on which the election is made;
- the first payment with respect to such election is deferred for a period of not less than five years (if the distribution is not triggered by disability, death, or unforeseen emergency); and
- the change is made not less than 12 months prior to first scheduled payment if the payment is related to a payment at a specified time (or pursuant to a fixed schedule) specified under the plan.

**Notice 2005-1** - IRS set forth the following exceptions to the general prohibition on accelerating the time or schedule of any payment:

- payments to someone other than the participant that are needed to fulfill a domestic order.
- payments necessary to comply with federal rules against conflicts of interest,
- the minimum amount needed to pay withholding taxes upon a vesting event under Code Section 457(f), and
- the minimum amount necessary to pay FICA taxes required by Code Section 3121(v)(2).

In addition, a plan may be amended at any time to add a provision permitting automatic lump sum payment of not more than \$10,000 upon the termination of a participant's entire interest in a plan, provided the distribution is made reasonably promptly, i.e., within 2-1/2 months of the participant's separation from service or, if later by the end of the calendar year containing the separation from service date.

**Proposed Regulations** - The proposed regulations provide the following clarifications:

**Annuity** - A participant will be allowed to switch from one type of life annuity to another before the annuity starting date if the annuities are actuarially equivalent under reasonable actuarial assumption. Participants may switch from a life annuity to a lump sum payment at least five year after the annuity payment were scheduled to begin.

**Installments** - Installments are treated as a single payment, but a plan may provide for treating each individual installment as a separate payment. If

installments are treated as a single payment, a set of installments could be switched to a lump sum that is payable five years after the first installment payment. If each installment is treated as a separate payment, switching to a lump sum would require delaying payment until five years after when the last installment would have been paid.

**Plan termination** - payments may be accelerated upon plan termination in only three situations:

- Within the 30 days preceding or 12 months following a change in control of a corporation;
- Upon a corporate dissolution or with approval of a bankruptcy court as long as certain requirements are met;
- If the employer is terminating an entire category of plans for all participants. No payments can be made on account of plan termination within the first 12 months, all payments must be made within 24 months and no successor plan can be established within 5 years.

## **XI. Funding**

**Law Before 2005** - Amounts deferred could be set aside in a Rabbi Trust or other arrangement in which the assets were subject to claims of the employer's creditors.

**Code Section 409A** - Domestic Rabbi Trusts generally are still permitted, except for "springing" provisions based on an employer's financial health.

Any assets set aside in, or transferred to, a trust outside the United States are treated as having been transferred to the employee (and thereby are includible in income in the current year whether or not such assets are available to satisfy claims of general creditors) except if substantially all of the services to which the deferred compensation relates are performed in such foreign jurisdiction.

Amounts deferred are currently includible if the plan provides that, upon a change in employer's "financial health" (as defined in IRS regulations) assets will be restricted to the payment of nonqualified deferred compensation.

## **XII. Penalties for Noncompliance**

**Law Before 2005** - If any of the taxation rules discussed above were violated, deferred amounts were included in the participant's income.

**Code §409A** - If deferred compensation is includible in income because of a violation of the above funding restrictions or the deferral rules, then any amounts deferred are taxable. In addition, the tax imposed on such deferrals is increased

by: (i) interest at the underpayment rate of 1% as if the deferred compensation had been included in the employee's income in the taxable year in which first deferred or, if later, when not subject to a substantial risk of forfeiture; and (ii) an amount equal to 20% of the deferred compensation included in income.

**Notice 2005-1** - IRS does not provide for any transitional relief. In applying the penalty provisions, IRS provides that each employee is treated as having his or her own separate plan and other participants are not affected. In addition, if an employee is a participant in more than one account balance plan, more than one nonaccount balance plan or more than equity based plan, then all of the employee's plans within that category will be aggregated and treated as a single plan.

**Proposed Regulations** - IRS provides that severance pay plans or separation pay arrangements are considered an additional type of nonqualified plan.

### **XIII. Annual Reporting**

**Law Before 2005** - Compensation was not separately reported to the IRS when deferred.

**Code Section 409A** - Employers would have to report on Form W-2 the amount of compensation deferred each year (subject to de minimis rules set by IRS). A similar rule requires reporting on Form 1099 of amounts deferred with respect to an independent contractor.

**Notice 2005-1** - IRS provides the mechanics of reporting nonqualified deferred compensation on either form. However, the determination of amounts that are includible income and subject to withholding as a result of Code §409A is left to future guidance. In the case of nonaccount balance plans, year-by-year reporting of deferral can be delayed until the amounts are considered reasonably ascertainable based on the regulations under Code Section 3121(v)(2).

### **XIV. Grandfather and Transition Rules**

The IRS provides a number of grandfather and transitional rules in both Notice 2005-1 and the proposed regulations. This guidance includes:

- **Reliance, Good Faith Compliance and Delayed Plan Amendment** – Since the final regulations under Code Section 409A will not be effective until January 1, 2007, plans must operate pursuant to a good faith interpretation of Code Section 409A. Taxpayers may rely on Notice 2005-1 and if the final regulations are less favorable, the IRS will apply these new rules prospectively with adequate transition relief to permit plans to be modified. Pending additional guidance on Code Section 409A for topics that are not covered by Notice 2005-1. Taxpayers are not required to comply with the

proposed regulations during the good-faith compliance period, although in some cases it may be advantageous or advisable to do so because compliance with the proposed or final regulations will be deemed to be good faith compliance with the statute.

Plan amendments to comply with Code Section 409A may be made as late as December 31, 2006.

- **Certain Severance Plans Excepted for 2005** - Severance plans that are collectively bargained or cover no key employees do not need to comply with Code Section 409A in 2005, provided they are amended by December 31, 2005.
- **Right to Cancel Deferrals** - A plan adopted before December 31, 2005 may be amended (but need not be) to allow a participant during 2005 to terminate participation or cancel a deferral election (in whole or in part) with respect to amounts subject to Code Section 409A. The plan must be amended by December 31, 2005 and related amounts must be timely included in income. The amendment need not apply equally to all participants. In addition, the plan aggregation rules do not apply, so separate plans of the same type may be treated differently.
- **Late Deferral Elections Permitted** - For plans in existence by December 31, 2004, deferral elections can be made by March 15, 2005 and be treated valid under Code Section 409A. The election can cover any amounts that have not yet been paid (or become payable) when the election is made.
- **Form of Payment May Be Linked to Qualified Plan in 2005 and 2006** - Through December 31, 2006, determining the form of payment under a nonqualified plan based upon the participant's election under a qualified plan will meet Code Section 409A, provided that this linkage is in accordance with the nonqualified plan's terms as of October 3, 2004.
- **Plan Termination Permitted Until December 31, 2005** - In general, a plan sponsor may not have or exercise discretion to terminate a plan that is subject to Code Section 409A and then make distributions. However, a plan sponsor may terminate and make distributions from a pre-October 4, 2004 arrangement on or before December 31, 2005, without it being a material modification that could trigger penalties under Code Section 409A.
- **Discretion Under Grandfathered Plans** - If the terms of a plan on October 3, 2004 permitted the employer to exercise discretion over time and manner of payment, it is not a material modification for the employer to exercise this discretion after 2004. Similarly, it is not a material modification for a participant to exercise a right permitted under the plan on October 3, 2004.

- **Withholding** - Amounts that are includible in income solely because of Code Section 409A need not be treated as wages subject to withholding until December 31, 2005.
- **New Distribution Elections** - With respect to amounts subject to Code Section 409A, an employer may amend its plan to provide for new distribution elections for amounts that were previously deferred. The new distribution election will not be treated as a change in form and time of payment under Code Section 409A provided that the election and the plan amendment are in place before December 31, 2006. However, there is still no relief from constructive receipt, and 2006 elections may not apply to payments that would otherwise have been received in 2006 or to cause payments to be made in 2006.

#### **XV. Recommended Course of Action by the end of 2005**

Before the end of 2005, it is recommended the following steps be taken:

- Identify all arrangements that could be subject to Code Section 409A;
- Decide if any grandfathered arrangements will be terminated and if so make any necessary amendments to act this year;
- Cancel participation of some or all participants, resulting in taxable payments of the cancelled amounts in 2005;
- Determine any amounts under those deferred compensation arrangements that will continue that were earned and vested at the close of 2004 and determine whether these amounts should be kept separate from post 2004 deferred amounts; and.
- Execute salary deferral elections by December 31, 2005 for amounts to be deferred for 2006,