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What is Internal Revenue Code (IRC) Section 409A?

IRC Section 409A, added by the American Jobs Creation Act of 2004, is the first comprehensive legislation aimed directly at employer nonqualified deferred compensation (NQDC) plans . If a NQDC plan meets the requirements of Section 409A, plan benefits generally aren't subject to federal income tax until paid to participants. But, if a NQDC plan fails to meet Section 409A requirements, benefits are subject to tax and penalties as soon as they vest.

Caution: Congress left much of Section 409A's operational details to the IRS. On December 20, 2004, the IRS issued its first guidance, Notice 2005-1 . The Notice is detailed and complex. Many issues aren't yet addressed, some of the rules provided are temporary, and much more guidance is expected. This article, based on the statute, legislative history, and Notice 2005-1, will be updated as additional guidance is issued.
Caution: Section 409A does not replace any other laws or theories of taxation that have previously applied to NQDC plans. Even if compensation is not subject to tax under Section 409A, it may still be taxable under the constructive receipt doctrine, the economic benefit doctrine, the assignment of income doctrine, or other applicable law.

Plans subject to Section 409A Section

409A applies broadly to any plan that provides for the deferral of compensation. For Section 409A purposes, a plan includes any agreement or arrangement between a service provider and a service recipient, including an arrangement that covers only a single employee, director, or independent contractor. The broad definition of "plan" under Section 409A sweeps in not only the more common forms of NQDC plans (e.g., SERPs, unfunded excess benefit plans, voluntary deferral plans, and wraparound 401(k) plans), but also certain equity arrangements, bonus and incentive plans, Section 457(f) plans, and severance pay plans.

Tip: A service provider can be an individual (e.g., an employee) or a personal service corporation (or a non-corporate entity that would be a personal service corporation if it were a corporation). A service recipient is the person or entity for whom the services are performed (e.g., an employer).

Tip: Section 409A applies to arrangements between partners and partnerships that provide for the deferral of compensation, but Notice 2005-1 provides interim relief for certain arrangements (for example, the issuance of a profits or capital interest in a partnership in exchange for the provision of services).

Caution: An arrangement is not subject to Section 409A if both the service recipient and the service provider are accrual method taxpayers. Also, if a service provider (for example, an insurance broker) provides substantial services to multiple (unrelated) service recipients, and the service provider is not an employee or director of the service recipient, the arrangement will not be subject to Section 409A.

Since, in most cases, the relationship between the service provider and the service recipient will be that of employer/employee, for convenience these terms are used throughout the rest of this article. Keep in mind, however, that the law applies to other relationships as well.

Plans not subject to Section 409A Section 409A does not apply to the following plans:

- Qualified employer retirement plans
- Section 403(b) plans

- Section 457(b) plans
- SEPs
- SIMPLE IRA and SIMPLE 401(k) plans
- Incentive stock option plans under IRC Section 422 and employee stock purchase plans under IRC Section 423
- Archer medical savings accounts, health savings accounts, flexible spending accounts, and any other medical reimbursement arrangement
- Bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans
- Restricted property taxable under IRC Section 83 if there is no deferral feature
- 501(c)(18) trust (employee funded pension plans created before June 25, 1959)
- Qualified governmental excess benefit plans under IRC Section 414(m)

What is "deferred compensation" under Section 409A?

IRC Section 409A applies only to plans that provide for a deferral of compensation. Deferred compensation is compensation that an employee has a legally binding right to receive that is payable to, or on behalf of, the employee in a later year. Whether or not compensation is deferred compensation depends upon the terms of the compensation plan and the surrounding facts and circumstances. Deferred compensation under Section 409A also includes all earnings on employee deferrals.

A significant exception exists for compensation paid to an employee shortly after it vests (that is, after the compensation is no longer subject to a substantial risk of forfeiture). Until the IRS issues further guidance, a plan doesn't provide for the deferral of compensation (and therefore Section 409A does not apply) if the plan provides that compensation will be paid to an employee within 2½ months after the later of the employee's taxable year in which the compensation vests, or the employer's taxable year in which the compensation vests.

Example(s): On January 1, 2005, ABC Company promises its employee, John, it will pay $50,000 if John is still employed by ABC on January 1, 2015. If John separates from service before that date, the $50,000 is forfeited. If John is still employed on January 1, 2015, the $50,000 will be paid on March 1, 2015. John does not have a right to defer the payment to a later date. This is not a deferred compensation arrangement and Section 409A does not apply.
An incentive plan provides an award that is based on performance over a three-year service period from 2006 through 2008. No benefit is payable if the employee separates from service before the end of the three-year period. The award is payable on March 1, 2009 and employees cannot defer the payment beyond that date. This is not a deferred compensation arrangement and Section 409A does not apply.

Election requirements under Section 409A

Section 409A contains very specific rules that govern the timing of NQDC plan deferral elections. These rules codify many aspects of the constructive receipt theory of taxation that has traditionally applied to NQDC plans.

Initial election to defer compensation--general
In order to be a valid deferral, an employee's initial election to defer compensation must be made prior to the year the compensation is earned. Compensation is earned in the year the employee performs the services that result in the compensation. This initial election must specify the amount of the deferral, and the time and form of distribution. Or the plan itself can specify when and how payment will be made.

Tip: Multiple payout elections are permissible. For example, a plan can let employees elect to receive 25 percent of their account balance at age 50 and the remaining 75 percent at age 60. Or, a plan could allow employees to elect different forms of payment for different permissible distribution events. For example, an employee could elect to receive a lump-sum distribution upon disability, but an annuity at age 65.
In the past, it was common to let employees elect to defer the receipt of a bonus at any time before the start of the calendar year in which the bonus was to be paid. For example, if a bonus is earned in 2006, and the amount of the bonus is determined and payable in 2007, a plan might previously have allowed an employee to make an election to defer the bonus payment up until December 31, 2006. Section 409A no longer permits this. In this example, the employee's election to defer the bonus must be made by December 31, 2005; that is, before the year the bonus is earned. However, if a bonus qualifies as performance-based compensation (discussed below), a later election date may be possible.

Special rule for new plan participants

A special rule applies in the year an employee first becomes a plan participant. In this case, an employee can make an initial deferral election up to 30 days after becoming a participant. The deferral election can't be retroactive; that is, the election can apply only to compensation earned after the date of the election.

Special rule for performance-based compensation

Elections to defer performance-based compensation may be made up until six months before the end of the service period. Notice 2005-1 contains a temporary definition of performance-based compensation. Until further guidance is issued, a bonus that's based on services performed over a period of at least 12 months will be treated as performance-based compensation if: (a) the payment is contingent on the satisfaction of organizational or individual performance criteria, and (b) the performance criteria are not substantially certain to be met at the time of the deferral election.

Tip: Note that this rule allows deferral elections to be made after the start of the calendar year in which the compensation is earned.

Example(s): A bonus is earned in 2006 and payable in 2007. If the bonus qualifies as performance-based compensation, an employee can elect to defer payment of the bonus at any time up until June 30, 2006.
An incentive plan provides an award that is based on performance over a three-year service period from 2006 through 2008. No benefit is payable if the employee separates from service before the end of the three-year period. The award is payable in April of 2009. If the arrangement qualifies as performance-based compensation, the employee can elect to defer the payment at any time up until June 30, 2008.

Caution: Bonuses based on a performance period of less than 12 months, and bonuses paid without regard to performance, are not eligible for this special rule. An election to defer these payments must be made before the start of the calendar year in which the bonus is earned.

Subsequent elections

After employees make their initial deferral elections, a NQDC plan can allow subsequent elections (often called "second elections") that further delay or change the form of benefit payments from the plan. These subsequent elections are subject to all of the following requirements:

Payments can't be accelerated.

- The election can't take effect for at least 12 months; that is, the election must be made at least 12 months in advance of its effective date.
- If an employee elects to defer the start date of benefit payments, the new start date must be at least 5 years later than the originally scheduled start date. (This rule does not apply to distributions on account of death, disability, or unforeseeable emergency.)
- If the election relates to a benefit that is to be paid at a specified time in the future, the election must be made at least 12 months before the date of the first scheduled payment.
- Elections can no longer be tied to qualified plan elections
- Section 409A's new election rules effectively end the common practice of tying NQDC plan distributions to payout elections under an employer's qualified plan. This is because Section 409A requires that employees elect the form and timing of NQDC plan payments in their initial deferral election.

Tip: NQDC plans that tie the form or timing of benefit payments to an employee's election under a qualified plan can continue to apply these rules to benefit payments that start in 2005 (but not later), provided the payments are made in accordance with the terms of the NQDC plan as of October 3, 2004.

Plan distribution requirements under Section 409A

Section 409A prescribes six specific events that can trigger a distribution from a NQDC plan:

- Separation from service
- Death
- Disability
- Change in control event
- Unforeseeable emergency
- Specified time or pursuant to a fixed schedule
- The IRS hasn't yet issued guidance on distribution events other than those relating to a change in control.

Tip: While plan termination is not listed as a distribution event, a special transition rule allows an employer to terminate a NQDC plan in 2005 and distribute benefits to participants.

Separation from service

NQDC plan distributions are permitted when an employee separates from service. If a key employee of a publicly-traded company is entitled to a distribution of benefits from a NQDC plan on account of a separation of service, distribution of the benefits to the key employee can't begin until six months following separation.

Tip: Whether an employee is a key employee is determined under the qualified plan "top-heavy" rules found in IRC Section 416(i). This generally includes 5 percent owners of the employer, 1 percent owners of the employer who earn more than $150,000, and officers who earn more than $135,000 (in 2005). No more than 50 officers (or, if less, the greater of 3 or 10 percent of employees) are treated as key employees.

Example(s): Acme Corporation has 20 employees and four are officers: Andre, the CEO, who owns 100 percent of the company and earns $160,000; Bob, the president, who earns $150,000; Sarah, the CFO, who earns $140,000; and James, the treasurer, who earns $135,000. In this case, three officers--Andrea, Bob, and Sarah--are considered key employees (because 3 is greater than 10 percent of the total number of employees). Even though James earns $135,000, he is not considered a key employee.

Death and disability

Employees are considered disabled if: (a) they meet the Social Security definition of disability; that is, they are unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment that can be expected to result in death, or can be expected to last for a continuous period of not less than 12 months; or (b) they are receiving disability payments under an employer disability plan for a period of at least three months because of a medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months.

Change in control event

Notice 2005-1 allows a NQDC plan to make a payment of benefits upon a change in the ownership of the corporation, a change in effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation.

Unforeseeable emergency (hardship)

An unforeseeable emergency is defined as a severe financial hardship to the employee resulting from: (a) an illness or accident of the employee, the employee's spouse, or a dependent; (b) loss of the employee's property due to casualty; or (c) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the employee. The amount of the distribution must be limited to the amount needed to satisfy the financial hardship, plus any taxes reasonably anticipated as a result of the distribution. Distributions aren't permitted to the extent the hardship can be relieved through reimbursement by insurance or otherwise, or by liquidation of the employee's other assets (unless the liquidation would itself cause a severe financial hardship).

Specified time or pursuant to a fixed schedule

Benefit payments may be made at a specified time, or pursuant to a fixed schedule. Benefits can't be paid upon the occurrence of an event. For example, benefits payable when an individual attains age 65 are allowed because the benefits are payable at a specified time. However, benefits may not be paid when an individual's child begins college, because this is the occurrence of an event.

Acceleration of benefits requirement

In general Section 409A prohibits a plan from accelerating the payment of an employee's NQDC plan benefit except as permitted by the IRS. In Notice 2005-1, the IRS allows the acceleration of benefits from a NQDC plan in the following limited circumstances:

- To satisfy a qualified domestic relations order (QDRO)
- To comply with a conflict of interest divestiture
- To pay certain FICA taxes relating to the deferred compensation
- To pay income taxes due to the vesting of benefits in a Section 457(f) plan
- To cash out small benefits ($10,000 or less) upon an employee's separation from service. A plan that doesn't contain a small benefit cash-out provision can add one for both past and future deferrals.
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Tip: It is important to distinguish the acceleration of payments from the acceleration of vesting. Notice 2005-1 explains that an employer can accelerate vesting at any time (e.g., as part of an early retirement package) without triggering taxation under Section 409A, as long as benefits are payable only as a result of one of Section 409A's permissible distribution events (e.g., separation from service).

Example(s): A NQDC plan provides for a lump sum payment of an employee's vested benefit upon separation from service. Benefits generally vest under the plan after 10 years of service. An employee with 5 years of service is approaching retirement. It is not a prohibited acceleration of benefits under Section 409A for the employer to reduce the vesting requirement from 10 to 5 years of service, even if the employee becomes fully vested as a result and qualifies for a payment from the plan in connection with a separation from service. However, the benefit payment can not be accelerated.

Mandatory lump-sum distribution not prohibited acceleration

It isn't a prohibited acceleration of benefits for a plan to distribute an employee's account in a lump sum if the employee's account balance is less than a certain dollar amount at the time benefits become payable under the plan. For example, a plan can provide that account balances in excess of $50,000 will be paid in the manner elected by the participant, but account balances of $50,000 or less will automatically be paid in a lump sum, regardless of the distribution form selected by the employee. A plan that doesn't currently contain this type of provision can be amended to add one, but only for future deferrals.

Choice between comparable benefits not prohibited

Section 409A's legislative history indicates that it isn't a prohibited acceleration for a plan to offer the choice between cash and taxable property if the tax consequences are the same regardless of the choice. For example, the choice between a fully taxable annuity contract and a fully taxable lump-sum payment should be allowed under Section 409A. Also, the choice between different forms of actuarially equivalent life annuity payments should not result in a prohibited acceleration of benefits.

"Haircut" provisions prohibited

In the past, a number of techniques evolved that purported to allow employees to have virtually unlimited access to their NQDC plan benefits without triggering immediate taxation. One of these techniques was the so-called "haircut" withdrawal. Employees could request an early distribution at any time if they agreed to forfeit a percentage (usually 10 percent) of the benefit payment. These acceleration provisions are now prohibited under Section 409A (except for grandfathered benefits, as discussed under "Effective date and transition rules," below).

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Plan funding requirements

Offshore trusts and other arrangements
Benefits informally funded by a rabbi trust aren't generally subject to current taxation if the rabbi trust's assets are subject to the claims of the employer's general creditors. Some employers, however, have in the past funded their rabbi trusts with offshore investments that for all practical purposes were beyond the reach of the employer's creditors.

Section 409A effectively prohibits the investment of NQDC plan assets outside of the United States by taxing such assets at the time they're set aside in a trust (or other arrangement specified by the IRS) as a transfer of property from the employer to the employee. If trust assets are originally located in the United States, they're subject to tax when transferred offshore. Any subsequent increase in the value of the assets is treated as an additional taxable transfer of property. Amounts included in an employee's gross income are subject to an additional 20 percent penalty tax, plus interest.

Tip: The IRS has the authority to exempt arrangements that do not result in an improper deferral of U.S. tax and will not result in assets being effectively placed beyond the reach of creditors.

Tip: The prohibition on offshore trusts does 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 that foreign jurisdiction.

Triggers based upon the financial health of the employer

If a NQDC plan provides that assets will be restricted to the payment of plan benefits upon a change in the employer's financial health, those assets will be subject to tax as a transfer of property from the employer to the employee. Amounts included in income are also subject to an additional 20 percent penalty tax, plus interest. Any subsequent increase in the value of the restricted assets is treated as an additional taxable transfer.

If a NQDC plan provides that upon a change in the employer's financial health assets will be transferred by the employer to a rabbi trust, those assets will be subject to current taxation and penalties under Section 409A. This effectively prohibits what had been a fairly common NQDC plan practice.

Caution: Even if a transfer of assets does not actually take place, if the plan language provides for that contingency, then the plan assets that may be restricted are subject to tax and penalties under Section 409A.
This provision does not apply when assets are restricted for a reason other than a change in the financial health of the employer. For example, assets can be restricted upon a change in control of the employer.

What happens if a plan doesn't comply with Section 409A?

In general
If a plan doesn't comply with Section 409A for any year, there are three significant tax effects:

All amounts deferred for that year, and all prior years, that have not previously been taxed are subject to federal income tax immediately if vested (that is, they aren't subject to a substantial risk of forfeiture). If not vested, deferrals are taxed as they vest.
The amount included in income is subject to an additional 20 percent penalty tax. Interest is imposed.
These adverse tax effects apply only to the participants affected by the plan failure. There are generally two ways a plan can fail to comply with Section 409A. These are a plan document failure and an operational failure.

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A plan document failure occurs when the plan contains provisions that aren't allowed under Section 409A. An operational failure occurs when the plan terms are consistent with Section 409A, but the employer operates the plan in a way that violates Section 409A. For example, the employer may let a single employee accelerate the payment of benefits in violation of the terms of the plan and Section 409A. In this case, only the participant who was actually given the right to take an early distribution is affected by the plan failure, and only that employee will be subject to immediate taxation under Section 409A.

Substantial risk of forfeiture

A substantial risk of forfeiture exists if an employee's right to deferred compensation is conditioned on the employee's performance of substantial future services, or on the occurrence (or nonoccurrence) of some event, and the possibility of forfeiture is substantial if the condition isn't satisfied. Non-compete agreements don't create a substantial risk of forfeiture for Section 409A purposes. The risk of forfeiture must exist at the time of initial deferral. A risk of forfeiture added (or extended) later is disregarded. For example, a rolling risk of forfeiture--where the employee or employer can extend a forfeiture provision before it expires--does not create a substantial risk of forfeiture under Section 409A.

Application of Section 409A to specific arrangements

Severance pay plans

Severance pay plans are generally subject to Section 409A. However, if all severance benefits are paid to an employee within 2½ months after separation from service, Section 409A should not apply. Also, severance plans that are either collectively bargained, or do not cover key employees, will not have to comply with Section 409A during calendar year 2005.

Stock appreciation rights (SARs)

Stock appreciation rights (SARs) are deferred compensation plans under which employees are entitled to a payment (usually in cash) equal to the appreciation in the value of a share of the employer's stock from the grant date of the SAR to the exercise date. SAR's are generally subject to Section 409A. However, the IRS has indicated that a SAR program will generally comply with Section 409A if the plan provides for a fixed payment date.

Notice 2005-1 also grandfathers certain SAR plans in existence on October 3, 2004. Under this special rule, Section 409A does not apply, until further guidance is issued, if the exercise price of the SAR can never be less than the fair market value of the underlying stock at the time of grant, and there are no deferral features (for example, the employee can't further defer the payment after the SAR is exercised). This special rule is available whether payment is made upon exercise of the SAR in cash or stock.

Notice 2005-1 also provides that Section 409A will not apply to a new SAR program if all of the following requirements are met:

- The exercise price of the SAR is never less than the fair market value of the underlying stock on the grant date
- The SAR is settled in stock rather than cash
- The stock is publicly traded
- There are no deferral features

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Tip: A special transition rule allows employers to cancel existing SARs and replace them with SARs that are exempt from Section 409A, if the cancellation and re-issuance occurs on or before December 31, 2005.

Nonqualified stock options

Nonqualified (nonstatutory) stock options are generally subject to Section 409A, but like SARs may be exempt if structured properly. Nonqualified stock options are exempt if: (a) the exercise price is never less than the fair market value of the underlying stock on the grant date; (b) the taxation of the options is governed by IRC Section 83; and (c) there are no deferral features (other than the deferral of recognition of income until the exercise or disposition of the option).

Technical Note: A special transition rule allows employers to cancel existing nonqualified stock options and replace them with options that are exempt from Section 409A as described above, if the cancellation and re-issuance occurs on or before December 31, 2005.

Restricted property (restricted stock, secular trusts, funded excess benefit plans, and nonqualified annuities)
Notice 2005-1 provides that Section 409A does not apply to the transfer of restricted property from an employer to an employee. Restricted property is generally property that an employee may forfeit if the employee fails to satisfy certain conditions (for example, working for a specified period of years). This rule applies, for example, to grants of restricted stock, transfers to nonqualified trusts taxable under Code Section 402(b) (for example, certain secular trusts), and transfers to nonqualified annuities taxable under Code Section 403(c). The Notice cautions, however, that the right to receive restricted property in the future may be a deferral of compensation subject to Section 409A.

Wraparound 401(k) plans

In a typical wraparound 401(k) plan , employees determine how much they want to defer in the aggregate to the employer's qualified 401(k) plan and the nonqualified deferral (wraparound) plan. The entire deferral flows first into the wraparound plan and then, at year's end, when the 401(k) plan's discrimination testing is complete, the maximum amount the employee is eligible to defer to the 401(k) plan is "transferred" from the wraparound plan to the 401(k) plan. It appears that this plan design may no longer be viable because it may be difficult, if not impossible, to satisfy Section 409A's election and distribution rules.

Tax reporting and withholding
Section 409A requires that employers annually report all NQDC plan deferrals to the IRS. Deferrals are reported on Form W-2 (for employees) or Form 1099 (for non-employees) for the year the compensation is deferred, even if the compensation is not currently includable in the employee's income that year. These new rules apply to amounts deferred after December 31, 2004 (and earnings on those deferrals). The employer must also continue to report deferred compensation on Form W-2 or Form 1099 for the year it's included in an individual's gross income. Any amount included in gross income because of Section 409A will be considered wages subject to income tax withholding.

Tip: For defined benefit SERPs, the deferred compensation doesn't have to be reported until the amounts become reasonably ascertainable (the IRS intends to issue further guidance on this).

Effective date and transition rules
The effective date provisions of Section 409A, as detailed in Notice 2005-1, are exceedingly complex, and a full treatment is beyond the scope of this article. In general, Section 409A applies to compensation deferred after December 31, 2004. However, a number of transition rules apply. Some of the more significant transition rules are set forth below.

Grandfathered benefits

Section 409A applies to compensation deferred in taxable years beginning after December 31, 2004. In general, amounts deferred prior to 2005 (and earnings on those deferrals) are not subject to Section 409A. For account balance plans (e.g., a deferral plan), the grandfathered amount is the employee's vested account balance on December 31, 2004. For non-account balance plans (e.g., a defined benefit SERP), the grandfathered amount is the present value of the employee's vested benefit as of December 31, 2004, determined as if the employee terminated employment on that date and received payment at the earliest possible date permitted under the plan. Pre-2005 deferrals are grandfathered only if they are earned and vested by December 31, 2004. Amounts are earned and vested only if they are not subject to a substantial risk of forfeiture or a requirement to perform future services as determined under IRC Section 83. If compensation deferred before 2005 vests after December 31, 2004, it will be subject to all of Section 409A's requirements.

Loss of grandfather status

If a NQDC plan in existence on October 3, 2004 is "materially modified" after that date, all deferrals under the plan, even those deferred prior to 2005, are subject to Section 409A. Notice 2005-1 provides detailed guidance on which plan amendments are, and are not, material modifications that result in the loss of grandfather protection, including:

- A material modification is presumed to occur if a benefit or right existing on October 3, 2004 is enhanced, or a new benefit or right is added. In some cases, an employer may be able to rebut this presumption.
- Amending a plan to bring it into compliance with Section 409A is not a material modification.
- Amending a plan to reduce existing benefits (for example, by deleting a haircut provision) is not a material modification.
- Amending a plan to add a new feature permitted by Section 409A (e.g., to allow payment upon an unforeseeable emergency) is a material modification.
- Amending a plan to stop future deferrals (i.e., freezing the plan) is not a material modification.
- Termination of a NQDC plan before December 31, 2005 is not a material modification if all amounts deferred under the plan are included in an employee's gross income in the year of termination.
- Canceling stock options or SARs that would be subject to the new Section 409A rules, and replacing them with options or SARs that are exempt from Section 409A's requirements, is not a material modification if completed before December 31, 2005.

Plan amendments and good faith compliance

NQDC plans must be operated in good faith compliance with the new law and Notice 2005-1 as of January 1, 2005. However, NQDC plan documents do not have to be amended to conform to Section 409A until the end of 2005.

New elections for prior deferrals

A significant transition rule allows employees to make new elections in 2005 that apply to compensation previously deferred under the plan. For example, an employee can change the form or timing of benefit payments, and even accelerate the payment date of prior deferrals without violating Section 409A. The NQDC plan must be amended by December 31, 2005 to take advantage of this special rule.

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Reducing 2005 deferrals or terminating participation

NQDC plans can allow an employee to terminate plan participation, or reduce or cancel 2005 deferral elections, provided: (1) the employee makes the election by December 31, 2005; (2) the plan is amended by that date; and (3) any amount subject to the termination or reduction is included in the employee's income in 2005 (or, if later, the year it becomes vested). An employer can also make this election for any employee or group of employees.

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