

Client
Advisory

Congress Passes New Legislation Governing Nonqualified Deferred Compensation

October, 2004

On October 11, 2004, Congress passed the American Jobs Creation Act of 2004 (the “Act”), which includes provisions that will impact most nonqualified deferred compensation arrangements. The provisions broaden the definition of what is considered a nonqualified deferred compensation plan (a “Plan”) and codify the IRS’ current positions on the tax treatment of deferred compensation. Under the new provisions, amounts deferred under a Plan, including earnings, are taxed immediately to the extent there is not a substantial risk of forfeiture, unless the specified requirements of the new rules are satisfied. If a Plan does not comply with the new rules, then amounts deferred under the Plan are subject to income taxation for the year of the initial deferral as well as penalties and interest provided for under the new rules. The new provisions also change the rules regarding deferred compensation invested under offshore trusts.

Definition of Plan

The Act defines a nonqualified deferred compensation plan as any plan, agreement or arrangement that provides for the deferral of compensation other than a “qualified employer plan” (e.g., a qualified retirement plan, 403(b) plan, SEP or SIMPLE) or any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. This definition captures a variety of arrangements that are not currently considered nonqualified deferred compensation plans.

For example, the new rules apply to stock appreciation rights, stock options granted with an exercise price that is less than the stock’s fair market value at the time of grant or arrangements which defer gains on the exercise of stock options. How these types of benefits are impacted by the new rules will need to be clarified by the Service.

The rules do not apply to annual bonuses or other forms of annual compensation if such amounts are paid out within two and one-half months after the end of the year in which the relevant services are performed.

Deferral Elections and Distributions

Under the new rules:

- **Deferral Elections.** These elections must be made no later than the tax year prior to the year in which the services giving rise to the compensation are performed or, for newly eligible participants, 30 days after the eligibility date. For any performance-based compensation based on services performed over a period of at least 12 months, the deferral election must be made at least six months before the end of the service period. Future regulations will define what constitutes performance-based compensation for these purposes.

- **Distribution Elections.** The time and form of distributions must be specified at the time of initial deferral. However, a Plan may permit a participant to make a subsequent election to extend the payment date for deferrals or to change the form of payment if (i) the election is not effective for at least 12 months after it is made, (ii) the election is made at least 12 months before the scheduled payment date, and (iii) for payments other than on account of death, disability or an unforeseeable emergency, the deferral is for an additional period of at least five years.
- **Commencement of Distributions.** A Plan can allow distributions only upon one of the following events: (i) separation from service (with special rules for key employees), (ii) disability, (iii) death, (iv) a fixed time (or pursuant to a fixed schedule) specified at the time of deferral, (v) a change in ownership or control of the company (as defined under regulations to be issued within the next 90 days), or (vi) the occurrence of an unforeseeable emergency.
- **Distributions to Key Employees.** A key employee of a public company may not receive a distribution based on separation from service until six months after the separation. For this purpose, a key employee is (i) an officer with annual compensation of at least \$130,000, (ii) a five-percent owner of the company, or (iii) a one-percent owner of the company with compensation in excess of \$150,000.
- **Accelerated Distributions.** Acceleration of payment, such as “haircut” provisions that permit early withdrawals with a penalty, will generally be prohibited, except in limited circumstances to be determined by the Service.
- **Change of Financial Health.** The new rules also provide for the immediate inclusion in income of deferred amounts if a plan provides that upon a change in the employer’s financial health, specific assets will become earmarked for payment of the deferred income. Thus, the use of a “rabbi trust” which becomes a regular trust upon the deterioration of the employer’s financial circumstances is no longer permissible.

Offshore Trusts

The new rules limit the use of offshore trusts to hold deferred amounts. Even if the assets of the trust are available to creditors in the event of the employer’s insolvency, vested participants will be currently taxable when assets are held in, or transferred to, a foreign trust. The Service is authorized to provide similar rules for non-U.S. entities other than trusts. These rules would generally not apply if an employee provides substantially all of his or her services in the foreign jurisdiction where the trust is located. The Service also has authority to exempt an arrangement to the extent the arrangement does not result in an improper deferral of U.S. tax and does not result in assets being effectively beyond the reach of creditors.

Penalties and Interest For Rule Violations

In the event a Plan violates any of the new requirements with respect to deferral elections or distributions, all vested deferrals under the Plan will be immediately taxable to the extent vested, but only for the participant to whom the violation relates. The tax consequences are not applied to the entire Plan or to all participants. The tax imposed will be increased by interest at the IRS underpayment rate plus 1%, measured from the later of the date of deferral or vesting, as well as an additional 20% tax penalty.

Effective Date and Future Guidance

When signed by the President, the new rules will apply to compensation deferred after December 31, 2004. Amounts deferred and vested before January 1, 2005 will still be subject to current rules, unless the Plan is materially modified after October 3, 2004.

Within 60 days following the enactment of the new rules, the Service must issue regulations to provide a limited transition period during which Plans may be amended to: (a) allow participants to terminate participation or cancel an outstanding deferral election for amounts deferred after December 31, 2004, and include such amounts in income as earned, and (b) conform post-December 31, 2004 deferrals to the new rules.

The Act also requires further guidance to be issued to: (i) provide for the determination of amounts of deferrals under defined benefit plans, (ii) define financial health, and (iii) describe when a substantial risk of forfeiture may be disregarded.

Reporting

Deferred amounts will need to be reported to the IRS and included on an individual's Form W-2 or Form 1099 for the year deferred, even if the amounts are not currently taxable.

Steps for Plan Sponsors

Most existing nonqualified deferred compensation arrangements will require revisions to ensure compliance with the new rules.

If you would like assistance in revising your current deferred compensation plans for the new rules, or have any questions about the Act, please contact:

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