

Congress Passes Sweeping Changes for Deferred Compensation Plans; Employers Must Act Quickly

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On October 11, 2004, Congress passed the American Jobs Creation Act of 2004 (the "Act"), which President Bush is expected to sign soon. The Act significantly revises the operation of nonqualified deferred compensation plans ("NDCPs"), and imposes severe tax consequences on amounts that are deferred under NDCPs that do not satisfy the requirements of the Act. Employers must respond quickly to the Act, as it applies to amounts deferred beginning in 2005.

WHAT PLANS ARE AFFECTED?

The Act broadly defines the term "nonqualified deferred compensation plan" to include any plan that provides for the deferral of compensation, other than (1) a qualified employer plan (e.g., 401(k)s, SEP and SIMPLE plans and eligible deferred compensation plans under Section 457(b) of the Internal Revenue Code), or (2) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. The Act also does not cover: (1) stock options that are granted at or above fair market value; (2) annual bonuses paid within 2-1/2 months after the year to which the bonuses relate; or (3) employee stock purchase plans under Section 423 of the Internal Revenue Code. However, this still leaves a broad array of NDCPs covered by the Act, including:

- Supplemental executive retirement plans ("SERPs")
- 401(k) "wrap" plans
- Restricted stock and phantom stock plans
- Performance incentive plans
- Stock options granted below fair market value
- 457(f) plans

The Act not only affects plans covering many employees, but also individual arrangements that provide for deferral of compensation. Plans that defer compensation paid to directors, independent contractors and consultants are also subject to the Act.

WHAT NEW RULES APPLY TO COVERED PLANS?

The Act requires that a covered NDCP must comply with new Section 409A of the Internal Revenue Code. If a covered plan does not comply with Section 409A, amounts deferred under the plan are subject to income taxes, interest and penalties (described in more detail later in this article) to the extent not subject to a substantial risk of forfeiture. If a plan contains a substantial risk of forfeiture provision but does not comply with Section 409A, the income taxes, interest and penalties will apply when the risk of forfeiture lapses.

Under Section 409A, covered NDCPs must follow specific requirements with respect to the timing of deferral elections, the timing of distributions, and the funding of the plan.

Timing of Deferral Election.

Participants in covered NDCPs must make their elections to defer compensation for a calendar year before the end of the preceding year. There is an exception for individuals who first become eligible to participate in a plan, who may make their initial deferral election within 30 days of becoming eligible. In addition, for performance-based compensation based on services over a period of at least 12 months, the election to defer such compensation may be made no later than 6 months before the end of the performance period.

Distribution Events.

The Act limits the events that may trigger a distribution under a NDCP. Distributions may commence only upon one of the following occurrences:

- Separation from service
- Death
- Disability
- At a specified time or pursuant to a fixed schedule that is clearly spelled out under the plan when the compensation is initially deferred
- A change in control of the employer
- An unforeseeable emergency resulting in severe financial hardship

Covered plans may not provide for an acceleration of benefits, except under circumstances that will be described in yet-to-be-issued regulations. For example, a plan that allows an employee to take an immediate distribution in exchange for forfeiting a portion of his or her deferred compensation (a so-called "haircut" provision) would not comply with the Act. The Conference Report for the Act identifies situations where regulations are expected to allow accelerated distributions, including cashouts of minimal plan interests upon separation from service, or to pay income taxes due upon a vesting event subject to Section 457(f) of the Internal Revenue Code.

The Act allows participants to make subsequent elections to change the time and form of distribution. However, such an election may not take effect until at least 12 months after the date of the election. The plan must provide that for distributions for reasons other than death, disability or an unforeseen emergency, the first payment with respect to which such election is made must be deferred for at least five years following the date that such payment would have otherwise been made. In addition, any election relating to payments that would be made under the plan's fixed timing or schedule must be made at least 12 months before the payment would otherwise be made.

Additional restrictions apply for "key employees" of public companies who participate in a covered plan. For such employees, payments from a covered plan that are triggered by a separation from service are prohibited any time during the first six months following the separation from service.

Plan Funding.

Many employers set aside money for NDCPs in a so-called "rabbi trust," which, if structured properly, does not result in current taxation to the plan participant. Under the Act, amounts set aside in an offshore rabbi trust, plus earnings on those amounts, will be subject to current income tax, as well as the interest and penalty provisions of the Act. In addition, if a covered plan provides that assets will become restricted to the payment of benefits under the plan upon a change in the employer's financial health, or if assets are in fact restricted to payment of plan benefits upon a change in the employer's financial health, such assets, plus earnings, will be subject to current income tax, as well as the interest and penalty provisions of the Act. This would be the result even if the amounts that are set aside upon the change in the employer's financial health are available to the employer's general creditors. According to the Conference Report, even assets placed in a rabbi trust due to a change in the employer's financial health would be subject to taxation, interest and penalties under the Act.

CONSEQUENCES OF FAILURE TO SATISFY THE ACT'S REQUIREMENTS.

If a covered plan's written terms or operation fail to satisfy the Act's requirements with respect to the timing or distribution of deferrals, all compensation deferred in the year of the failure and in all prior years by employees affected by the failure is subject to income tax. All amounts set aside in an offshore trust or a trust that becomes protected from creditors (or that makes distributions) upon certain changes in the employer's financial condition are subject to current income tax. The Act also imposes interest on these amounts and a penalty equal to 20% of the additional income.

GRANDFATHERING RULES

Amounts deferred before January 1, 2005, under a plan that complies with pre-Act law will not be subject to the Act unless the plan is materially modified after October 3, 2004. The Conference Report states that any addition of a benefit, right or feature would be a material modification.

However, the exercise of an existing benefit, right or feature would not be a material modification, nor would a plan amendment to remove a distribution provision be considered a material modification. In addition, the Conference Report states that amounts are considered deferred before January 1, 2005, only if the amounts are earned and vested before such date. Based on this language, amounts deferred under many Section 457(f) plans before January 1, 2005, might not be grandfathered, because in most cases such amounts would be subject to a substantial risk of forfeiture and unvested. Sponsors of 457(f) plans will have to wait and see if the IRS provides grandfathering relief for such plans when it issues regulations under the Act.

WHAT STEPS SHOULD EMPLOYERS TAKE NOW?

Although regulations need to be issued to interpret many provisions of the Act, employers should begin taking action now in light of the Act's 2005 effective date. We recommend that employers take the following steps:

1. Take an inventory of all NDCPs. This would include both formal written deferred compensation plans, as well as unwritten arrangements or employment agreements that provide for deferral of compensation.
 2. Determine which NDCPs are affected by the Act. Given the Act's broad scope, employers should expect that many of their nonqualified deferred compensation plans will be subject to the Act.
 3. Prepare and implement appropriate amendments to affected NDCPs. Before implementing new provisions, employers should consider the effect of the grandfathering provisions in the Act for amounts deferred under existing plans that are not materially modified after October 3, 2004.
 4. Communicate the new rules to plan participants and administrators. Participants should be made aware of how the new law will impact their deferred compensation expectations. Employees or outside consultants who administer covered plans should be actively involved in the implementation of the Act.
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