



Electronic Dispatch

Employee Benefits Law Action Memo

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NEW LAW MAKES EXTENSIVE CHANGES TO NONQUALIFIED DEFERRED COMPENSATION RULES IMMEDIATE ATTENTION REQUIRED

On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004, which includes extensive changes to the rules that govern "nonqualified deferred compensation plans." The new rules generally become effective for nonqualified deferred compensation amounts that are earned or become vested after December 31, 2004. Accordingly, employers (including tax-exempt employers) that offer or provide nonqualified deferred compensation arrangements should review those arrangements immediately to ensure that income recognition is deferred as desired and that income is reported and taxed as required.

Under new Internal Revenue Code ("Code") Section 409A, a "nonqualified deferred compensation plan" includes any plan, agreement or arrangement that provides for the deferral of compensation, including an agreement or arrangement for one person. This definition is broad enough to include individual employment contracts, severance pay plans, stock appreciation rights plans, "phantom" stock plans and any similar plan or arrangement. The definition also is broad enough to include agreements or arrangements for directors or other independent contractors. Excepted from the definition of "nonqualified deferred compensation plan" are bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans, as well as certain retirement plans (e.g., Code Section 401(k) plans, Code Section 403(b) tax-sheltered annuity plans and Code Section 457(b) eligible deferred compensation plans).

New Code Section 409A provides that, unless the nonqualified deferred compensation arrangement satisfies the new rules, deferred compensation earned or deferred after December 31, 2004 must be included in the covered individual's income at the time the amounts are or become vested. Because many nonqualified deferred compensation arrangements do not impose a vesting requirement, failure to comply with the new rules could result in immediate income recognition as the deferred compensation amounts are earned. Substantial interest and tax penalties also may be assessed, if the new rules are not satisfied.

Summary of the New Rules

Under the new rules, in order to avoid premature income recognition, and potential interest and penalty taxes, nonqualified deferred compensation arrangements must satisfy the following requirements:

Deferral Elections. Plans or arrangements that permit covered individuals to make voluntary elective deferrals of compensation (e.g., Code Section 401(k) "mirror" or "look-alike" plans) must be designed and operated to ensure that such deferral elections are made prior to the end of the taxable year that precedes the year during which the compensation will be earned. For example, compensation to be earned in 2005 may be effectively deferred only if the deferral election is made by December 31, 2004. As an exception to this election timing rule, individuals who first become eligible to participate in an elective deferral arrangement during the year may be given 30 days within which to make an initial deferral election with respect to compensation earned after the date of the election. Further, a special rule will apply to "performance-based compensation," such as bonuses earned on the basis of a calendar year. In the case of such compensation, an election to defer the payment must be made at least 6 months prior to the end of the measuring period. For example, a bonus that will be based upon performance during



calendar year 2005 and will be paid in calendar year 2006 may be deferred only if a deferral election is made by June 30, 2005. Guidance from the Internal Revenue Service is expected to address the effective deferral of bonuses earned for calendar year 2004 and payable during 2005. In the absence of such guidance, no portion of the 2004 bonus (paid in 2005) may be deferred.

Payment Elections. Deferred compensation arrangements in which the covered individual is allowed to select the payment date and/or the payment form generally must be designed and operated to require the covered individual to make such election(s) prior to the time the deferred compensation amounts are earned. For example, an arrangement that allows the covered individual to select the time and form of payment of amounts voluntarily deferred during 2005 must require the time and form of payment elections to be made by December 31, 2004. An affected individual may be given a right to make a subsequent election to delay the elected payment date and/or change the elected payment form, provided that the election does not take effect for at least 12 months, the new payment date is at least five years later than the original payment date, and (for scheduled payments) the election is made at least 12 months prior to the first scheduled payment date. Except in the case of an unforeseeable emergency (discussed below), an individual may not be allowed to accelerate the date of any payment, even if the individual agrees to forfeit part of his or her benefit in exchange for the "early" payment. (So-called "haircut" provisions are contrary to the new rules.)

Distribution Restrictions. All deferred compensation arrangements will have to be designed and operated to limit the circumstances under which deferred amounts may be distributed. Whether fixed in advance by the terms of the arrangement or selected by the covered individual prior to the time of deferral, deferred compensation may not be distributed earlier than: (i) the date the covered individual separates from service¹, becomes disabled or dies, (ii) the date(s) specified in advance under the plan or the individual's election, (iii) to the extent provided in regulations to be issued, the date of a change of ownership or control of the employer, or (iv) the date the individual demonstrates that he or she faces an unforeseeable emergency². A deferred compensation arrangement that permits distributions at a time or upon an occurrence other than those listed will not satisfy the new rules, and amounts deferred under the arrangement will be included in the covered individual's income when vested.

Funding Changes. Some deferred compensation arrangements are "funded" by the use of a grantor trust, commonly referred to as a rabbi trust. While deferred compensation arrangements may continue to use such trusts, all of the assets of the trusts must be located in the United States. Any transfer of trust assets outside the United States will be treated as a taxable transfer, resulting in immediate income recognition by the affected individual. Similarly, deferred compensation arrangements that provide for deferred amounts to be "secured" (by the restriction of employer assets set aside for deferred compensation purposes) upon a change in the employer's "financial health" will be treated as providing for a taxable transfer of assets to the covered individual as the deferred compensation amounts are earned.

New Reporting Requirements

Vested and non-vested amounts earned under all nonqualified deferred compensation arrangements, including those that satisfy new Code Section 409A, must be reported on the covered individual's Internal Revenue Service Form W-2 (or Form 1099 for non-employees) for the year the amounts are earned or first deferred. Vested amounts earned under a nonqualified deferred compensation arrangement that does not satisfy the applicable requirements of new Code Section 409A are subject to federal income tax reporting and withholding requirements.

Penalty Provisions

If a nonqualified deferred compensation arrangement fails to satisfy the applicable requirements of new Code Section 409A, in form or in operation, affected individuals must recognize income with respect to current and prior deferrals that are vested. In addition, an interest penalty will be assessed with respect to taxes owed on prior deferrals and all amounts included in income will be subject to an additional tax of 20 percent. In the case of an individual violation, and not a plan-wide violation, the penalty provisions will apply only to the affected individual and not the other individuals covered by the same arrangement.

Recommended Action

Because the new rules are effective with respect to amounts that are deferred or become vested after 2004 (and to amounts deferred under plans that are substantially amended after October 3, 2004), employers that sponsor or maintain deferred compensation arrangements should take immediate action. That action should include assembling all plans or arrangements that may be subject to the new rules; determining the extent to which changes must be made to bring the arrangements into compliance; evaluating whether existing arrangements should be "frozen" (and governed under prior income recognition rules) and new plans created to govern future deferrals; obtaining any necessary consents or approvals to make amendments and/or create new plans; and preparing appropriate communications to affected individuals.³ Public companies also will have to consider the extent to which disclosures to shareholders and the SEC will need to be modified prospectively.

If you have any questions about the new rules that apply to nonqualified deferred compensation plans, please contact any of the following members of our Employee Benefits Law Practice Group:

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¹ Key employees of public companies may not be paid earlier than six months after their separation from service. For this purpose, key employees are officers earning more than \$130,000 (indexed), five percent owners, and one percent owners earning more than \$150,000.

² An unforeseeable emergency generally is defined as a severe financial hardship resulting from an accident or illness of the individual or the individual's spouse or dependent, a loss of the individual's property due to casualty, or other similar circumstances beyond the individual's control.

³ Regulations to be issued by the Internal Revenue Service will provide additional guidance and transition relief that may impact an employer's final decisions.