Client Alert

LORD BISSELL BROOK LLP

New Deferred Compensation Legislation Requires Action By All Employers

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The American Jobs Creation Act of 2004, signed by President Bush on October 22, 2004, will significantly change how nonqualified deferred compensation will be taxed. As a result, all employers will need to review their nonqualified deferred compensation plans prior to January 1, 2005, to insure they will continue to operate as intended after that date.

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WHAT PLANS ARE SUBJECT TO THE NEW REQUIREMENTS?

Generally, all nonqualified deferred compensation plans are subject to the new requirements. A nonqualified deferred compensation plan (an "NQ Plan") is any plan that provides for the deferral of compensation, other than a "qualified employer plan" or a bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan is:

- A qualified retirement plan described in Section 401(a) of the Internal Revenue Code (the "Code"),
- An annuity plan described in Code Section 403(a),
- A plan established by the United States for its employees, or by a state or political subdivision or by an agency or instrumentality of any of the foregoing,
- An annuity contract described in Code Section 403(b),
- A simplified employee pension,
- Any simple retirement account,
- An eligible deferred compensation plan for state and local employees and tax-exempt organizations maintained under Code Section 457(b), or
- A qualified governmental excess benefit arrangement under Code Section 415(m).

A nonqualified stock option is not covered by these new rules if the exercise price is at least equal to the fair market value of the stock on the date of grant and the option does not have a deferral feature other than the right to exercise the option in the future. Qualified or incentive stock options, qualified employee stock purchase plans, or annual bonuses or other amounts paid within two and one-half months after the end of the taxable year in which services are performed are also not subject to these new rules. However, neither the statutory language nor the legislative history of the Act excludes stock appreciation rights or restricted stock units from coverage. Accordingly, they appear to be subject to the new rules.

An NQ Plan includes any agreement or arrangement, including an agreement or arrangement that includes only one person. Thus, an NQ Plan can consist of a single contract between an employer and an executive. The new rules are not limited to employees. Deferred compensation paid to a director, consultant or other independent contractor will also be subject to these new rules.

WHAT ARE THE NEW REQUIREMENTS?

There are three specific requirements that must be met to avoid an acceleration of taxation. These are a distribution requirement, an acceleration requirement, and an election requirement. If any of these requirements is not met, the deferred compensation will be taxed as soon as it is vested.

Distributions

The distribution requirement is met if the NQ Plan provides that compensation deferred under the plan may not be distributed to a participant earlier than:

- The date the participant separates from service,

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- The date that the participant becomes disabled,
- The date of the participant's death,
- A time (or times) specified under the NQ Plan at the date of the deferral (e.g., the participant's 65th birthday),
- To the extent provided by the Secretary in future guidance, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or
- The occurrence of an unforeseen emergency.

In the case of a "specified employee" of a public corporation, the separation from service requirement will be met only if distributions may be made no earlier than six months after the date of a separation of service (or, if earlier, the date of the death of the employee). A "specified employee" is any employee who is an officer of the corporation having an annual compensation greater than $130,000, a 5 percent owner of the corporation, or a 1 percent owner of the corporation having annual compensation from employer of more than $150,000.

An unforeseen emergency is defined as a severe financial hardship to the participant resulting from an illness or accident of the participant, the participant's spouse, or a dependent of the participant, loss of the participant's property due to casualty, or other similar or extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. A distribution will meet the unforeseeable emergency exception only if, the amounts distributed with respect to an emergency do not exceed the amounts necessary to satisfy such emergency, plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such hardship is or may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent the liquidation of such assets would not itself cause severe financial hardship).

Acceleration of Benefits

This requirement is met if the NQ Plan does not permit the acceleration of the time or schedule of any payment under the plan, except as may be provided in future regulations.

Elections

The new requirements include rules for initial elections and for changes in elections. The initial election requirement will be met if the NQ Plan provides that compensation for services performed during a taxable year may be deferred only if the election to defer such compensation is made no later than the close of the preceding taxable year, or at such other time as may be provided in the regulations. For the first year in which a person becomes eligible to participate in the NQ Plan, an election must be made within 30 days after the date the person becomes eligible to participate in the plan.

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For performance-based compensation based on services performed over a period of at least 12 months, the election must be made no later than six months before the end of the period. For example, if a participant is entitled to a bonus depending upon the performance of the employer over a 24-month period starting on January 1, 2005, the participant can elect to defer a portion of the bonus as long as the election is made no later than six months before the end of the 24-month period, or July 1, 2006.

For an NQ Plan that allows a subsequent election to delay a payment or change the form of payment, the plan must require that the deferral election not take effect until at least 12 months after the date on which the it is made. In the case of an election related to a payment other than by reason of disability, death, or unforeseen emergency, the NQ Plan must require that the first payment with respect to which the deferral election is made be deferred for at least 5 years from the date such payment would otherwise have been made. Lastly, with respect to any payments to be made at a specified time or pursuant to a fixed schedule, the NQ Plan must require the deferral election to be made no less than 12 months prior to the date of the first scheduled payment.

WHAT HAPPENS IF THESE REQUIREMENTS ARE NOT MET?

If at any time during a taxable year an NQ Plan fails to meet any of the three requirements described above, or is not operated in accordance with those requirements, then all compensation deferred under the plan for the taxable year and all preceding years is includable in gross income. However, inclusion is not required if the deferred amounts are subject to a substantial risk of forfeiture, or if they were previously included in gross income. Also, the inclusion in income only applies to the participant to which the failure applies.

If compensation is required to be included in gross income because of a failure, the tax imposed on that income is increased by both interest and an amount equal to 20 percent of the amount required to be included in income. With a current maximum individual tax rate of 35 percent, this latter provision could impose a federal tax of 55 percent on the taxable amounts. Interest is determined at the underpayment rate (currently 5 percent) plus 1 percent, and it applies to the underpayment in tax that would have occurred had the deferred compensation been includable in gross income for the year in which first deferred, or if later, the first year in which such deferred compensation is not subject to a substantial risk of forfeiture.

WHAT ARE THE NEW FUNDING RULES?

The new section also contains rules

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related to funding NQ Plans. The thrust of these changes is to prevent the avoidance of taxation on funded amounts by transferring those amounts offshore.

Under current law an employer can fund a deferred compensation agreement as long as the participant has no direct interest in the assets in the fund and the assets in the fund are subject to the employer's creditors. One of the typical ways in which nonqualified deferred compensation is funded is through a rabbi trust.

The new rules provide that where assets are set aside, either directly or indirectly, in a trust or other arrangement designated by the Secretary to pay deferred compensation, those assets will be deemed transferred to the participants, even if those assets are available to satisfy claims of creditors, at the time the assets are set aside, if they are located outside the United States, or at the time transferred, if such assets are subsequently transferred outside the United States. Similarly, property will be deemed transferred to the participant on the earlier of the date on which the plan first provides that assets will be restricted to the provision of benefits under the plan in connection with a change in the employer's financial health, or the date on which assets are so restricted, again whether or not such assets are available to satisfy the claims for creditors.

As with the inclusion in income required for failing to meet any of the three new requirements, if any amounts are includable income under these funding rules, they are subject to an interest charge and the 20 percent additional tax.

WHEN ARE THESE NEW RULES EFFECTIVE?

These new rules apply to deferrals after December 31, 2004. Therefore, it is necessary for every sponsor of an NQ Plan to review the plan to ensure that it will meet the new requirements. Amounts deferred under a plan prior to January 1, 2005, are not subject to these rules unless the NQ Plan is materially modified after October 3, 2004. Thus, an NQ Plan that does not meet these requirements but under which no additional amounts will be deferred, will not be subject to these new rules as long as the plan is not materially modified. However, if the sponsor wishes to continue the NQ Plan, then it will be necessary to amend the plan, effective as of January 1, 2005, to meet these new requirements.

Will a modification of an NQ Plan to meet the new requirements be treated as a material modification? The Act provides that no later than 60 days after the date of enactment, the Secretary of the Treasury is to issue guidance providing a limited period during which an NQ Plan adopted before December 31, 2004, may, without violating the three new requirements, be amended to conform to the new requirements for amounts deferred after December 31, 2004.

WHAT SHOULD YOU DO IF YOU HAVE AN NQ PLAN?

If you have an NQ Plan that you wish to continue after 2004, it needs to be reviewed to determine whether it satisfies the new requirements. If not, it will be necessary to amend the plan to do so. However, before any such amendment is made, you should await issuance of guidance by the Treasury to ensure that the changes that are made do not constitute a material modification that could result in the new rules being applicable to prior deferrals. Also, if at any time you desire to make a change to your NQ Plan, you should obtain qualified counsel that such change will not constitute a material modification that could result in an acceleration of tax consequences.

ABOUT THE AUTHORS

Larry Hansen and John Truskowski have significant experience in the areas of taxation and corporate law, with emphasis on employee benefits and executive compensation.

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