update

Staying Ahead

with Saul Ewing

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Employee Benefits

Deferred Compensation Arrangements After the American Jobs Creation Act of 2004

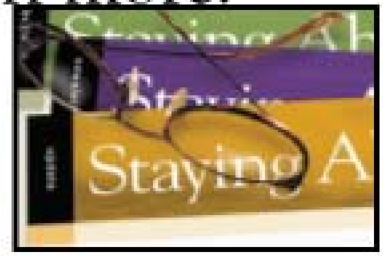
What happened?

Congress recently passed the American Jobs Creation Act of 2004, and President Bush signed the bill October 22, 2004.

What does it mean?

Along with a wide variety of tax changes, the new law imposes a system of statutory requirements on deferred compensation arrangements. Every such arrangement must now be reviewed and many will have to be modified.

Learn more.



Turn page to find out more.

Overview

The new law provides a definition of deferred compensation that will be explained in more detail through guidance to be issued by the Treasury Department. For those arrangements covered by the new law, distribution is limited to six specified events or circumstances. The new rules also deal with the method of electing to defer compensation, and prohibit the use of certain types of deferral funding mechanisms. The failure to comply with these rules will result in the loss of income tax deferral and the imposition of interest and penalties. Deferrals, whether or not taxable, must now be reported each year on Form W-2 or 1099. The new rules take effect January 1, 2005, and can, under some circumstances, affect amounts deferred before that date.

Arrangements Covered by the New Law

First, it is important to understand what is covered by the new law. New Section 409A of the Internal Revenue Code of 1986 (“Code”) applies to any plan, agreement or arrangement (including those that apply to only one person) that provides for the deferral of compensation, other than a qualified employer retirement plan or a bona fide vacation or sick leave, compensatory time, disability pay or death benefit plan. The new law applies to deferral arrangements for employees, independent contractors and directors. The new law should not apply to incentive stock options (Code Section 422) or employee stock purchase plans (Code Section 423) and probably not to any other stock option with (1) an exercise price at least equal to the fair market value on the date of grant and (2) no deferral other than the right to exercise the option. Many deferral arrangements will clearly fall within the statutory definition. For others, the question of coverage is not as clear. The new law requires that guidance be issued by the Treasury Department by December 21, 2004, and an important part of that guidance will be to assist in determining the range of compensation techniques covered by the new law.

Effective Date of the New Law

New Code Section 409A applies to amounts deferred after December 31, 2004. An amount will probably be considered deferred before that date if it is earned and the right to the deferred amount is vested by December 31, 2004. Amounts that have been deferred, but in which an employee or independent contractor is not yet vested by December 31, 2004 will be subject to the new law.

However, the new law will apply to amounts deferred before December 31, 2004 if the deferred compensation plan is materially modified after October 3, 2004. The definition of a material modification is not set forth in the statute, but the legislative history of the new law defines it as the addition of any benefit, right or feature. By contrast, the elimination of a benefit, right or feature is not a material modification. Until more definitive guidance is issued, care must be taken in making any changes in existing deferred compensation arrangements.

Restriction on Distribution Events

Under the new law, there are only six events that can give rise to distribution:

- separation from service
- disability
- death
- a specific time or a specific schedule
- an unforeseeable emergency
- a change in control

One limitation on the separation from service rule is that key employees of a publicly traded corporation may not receive distributions from deferred compensation plans until six months after separation from service. Key employees are officers earning more than $135,000 for 2005 (but not more than 50 individuals); employees who are 5% owners; and employees who are 1% owners and earn more than $150,000.

The legislative history indicates that payment at a specific time does not include payment when a particular event occurs. For example, payment when an employee’s child enters college would not satisfy the law.

The term change in control is not defined in the statute, but the legislative history suggests that a definition similar to, but more restrictive than, the golden parachute rules of Code Section 280G will be applied.

The term unforeseeable emergency is defined as a severe financial hardship to the individual arising from an illness or accident in the family, a casualty loss, or other extraordinary circumstances beyond the participant's control.

Prohibition on Acceleration of Payments

New Code Section 409A(a)(3) prohibits any deferred compensation plan from accelerating the time or schedule of payments under the plan. Treasury regulations might permit some exceptions to the prohibition on acceleration, such as for de minimis benefit amounts or to comply with a divorce decree.

Restrictions on Deferral Elections

Under the new rules, an election to defer income must be made before the taxable year in which the services giving rise to the deferred compensation are performed. There is an exception for the initial deferral by new plan participants: they must make the election not later than 30 days after becoming eligible to participate, with respect to income earned after the election is made.

A separate rule applies to performance-based compensation. For performance-based compensation that is based on services provided over a period of 12 months or more, the election to defer the compensation may be made up to six months before the end of the election period.

Changing the Time and Form of Distributions

Many existing deferred compensation arrangements permitted participants to change the time when payments were made. The new rules limit the ability to make such changes. There are three such limitations:

- An election to defer to a later date the receipt of deferred compensation may not take effect within 12 months from the date it is made.

- For a distribution to be made on separation from service, at a specified date or on a fixed schedule, or as a result of a change in control, the extension of the deferral period must be at least five years from the date the payment would otherwise have been made.

- For a payment to be made at a specified date on a fixed schedule, the further deferral election cannot be made within 12 months of the first scheduled payment.

Limitations on Funding Mechanisms

The new law also deals with funding arrangements for deferred compensation. Two types of funding arrangements will result in immediate taxation of the amounts deferred. First, assets that are used to fund deferred compensation and that are held in trusts based outside the US will result in the loss of deferral. If assets are held within the US and are subsequently transferred outside the country, taxation will occur when the transfer is made. Second, if assets will become restricted to the provision of benefits under the deferred compensation arrangement when there is a change in the employer's financial health, the deferral will be taxed to the participant immediately.

Reporting and Withholding of Tax

Another new provision of the Internal Revenue Code, Section 6051(a)(13), requires that the amount of all deferrals be reported on Form W-2 (for employees) or Form 1099 (for non-employees). Reporting is required even if the deferral amount is not currently taxable. In addition, amounts that become taxable to employees under Section 409A are subject to income tax withholding.

Penalties

The new deferred compensation rules contain significant penalty provisions. If a deferral does not satisfy the rules of Section 409A, the deferral of income will not be effective and the amount deferred will be included in taxable income for federal income tax purposes. In addition to the income tax liability, new Section 409A requires the payment of interest from the time the tax would have been due if there had been no deferral of income. The interest rate is the IRS underpayment rate plus one percent. Further, a penalty tax of 20% of the amount includible in income must be paid if the deferral does not meet the statutory requirements.

These rules as to income inclusion and penalty and interest payments apply only to those participants in the deferred compensation arrangement as to whom the statutory requirements are not met. If the deferral is lost because of action taken with respect to only one participant, only that participant will suffer the consequences. If the entire plan or arrangement fails to satisfy the law, then everyone will be penalized.

What To Do Now

The Treasury Department representatives who have discussed the new law have emphasized that its aim is not to trap employers. We expect that the guidance to be issued will give some transitional relief. It's important, though, to start planning for the changes now. We suggest the following steps:

- Identify all nonqualified deferred compensation arrangements, including plans, employment agreements and other individual compensation arrangements, whether with employees, directors or independent contractors.

- For each such plan or arrangement, determine whether there are provisions that do not comply with the new rules under Section 409A.

- Consider grandfathering existing plans to ensure that they do not become subject to the new rules.

- Notify participants that changes might have to be made in their deferrals.

- Continue to monitor developments with respect to the new law.

- Prepare to amend or terminate plans and arrangements after the Treasury Department guidance is issued in December.

To discuss how your business can ensure compliance with the new rules, please contact Bob Louis or Joan Corcoran. Mr. Louis can be reached at (215) 972-7155 or at rlouis@saul.com. Ms. Corcoran can be reached at (410) 332-8691 or at jcorcoran@saul.com. The contents of this Update are intended for informational purposes only, and should not be considered legal advice.