update

Staying Ahead

with Saul Ewing

10 | 04

Employee Benefits

The New World of Deferred Compensation: Immediate Action Needed

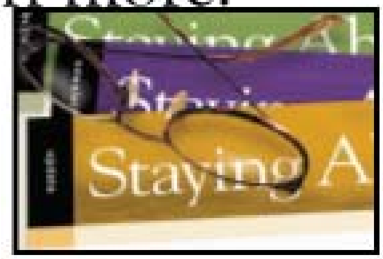
What happened?

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

What does it mean?

The new law contains a wide range of provisions affecting the tax liabilities of individuals and businesses. Perhaps none has a broader effect than the changes in the taxation of nonqualified deferred compensation. These changes require action by the end of the year by any business that maintains these kinds of arrangements for employees.

Learn more.



Turn page to find out more.

Congress recently passed the American Jobs Creation Act of 2004, and President Bush signed the bill on October 22, 2004. The new law contains a wide range of provisions affecting the tax liabilities of individuals and businesses. Perhaps none has a broader effect than the changes in the taxation of nonqualified deferred compensation. These changes require action by the end of the year by any employer that maintains these kinds of arrangements.

Many employers have in place nonqualified deferred compensation arrangements, usually in addition to qualified retirement plan benefits. Nonqualified deferred compensation is a valuable means of providing incentives to management employees and others. The Internal Revenue Service and other tax authorities have long been concerned that nonqualified deferred compensation arrangements were being abused. Before the new law was passed, the IRS announced an extensive audit program for deferred compensation arrangements, as well as other forms of management compensation, to ensure that plans were being carried out properly, and concluded from its preliminary efforts that many such arrangements were not complying with either the existing tax law or the terms of the deferred compensation arrangements. The new law reinforces the level of concern with these arrangements. Qualified retirement plans have long been subject to detailed regulation, and now nonqualified deferred compensation will begin to be regulated more extensively.

What plans are affected?

The new law adds new Section 409A to the Internal Revenue Code, which covers any plan providing for the deferral of compensation. Excluded are vacation, sick leave, compensatory time, disability and death benefit plans, qualified retirement plans, tax-sheltered annuities, SEPs, SIMPLEs, and Section 457(b) plans for tax-exempt entities. Plans such as supplemental executive retirement plans, phantom stock plans, performance incentive plans, below market stock options, and Section 457(f) plans are covered by the new law.

What are the changes?

The new law contains limitations on the event that can give rise to distributions. Distributions may only occur upon a separation from service, disability or death of the employee, change in ownership or control of the employer (yet to be defined) or an unforeseeable emergency, such as a severe financial hardship. Many plans formerly allowed a distribution to occur if the employee agreed to accept a slightly reduced amount, usually called a haircut provision. Those kinds of distribution provisions will no longer be allowed.

The acceleration of distributions under deferred compensation plans will be prohibited under the new law, except for de minimis amounts less than $10,000. The postponement of distributions will be permitted, but only in very specific circumstances and well in advance of when the distribution would otherwise be received.

The rules on deferral elections are also changed by the new law. An election to defer compensation for a taxable year must be made not later than the end of the preceding taxable year. There is an exception for initial deferrals, and for certain kinds of performance-based compensation.

Many deferred compensation arrangements are secured to some extent by trusts, often referred to as rabbi trusts. The new law denies tax deferral if the rabbi trust is based outside the U.S., or if the trust assets are restricted to the payment of benefits only upon a change in the employer's financial health. In other situations, rabbi trusts (so named because the first IRS ruling on the subject was with respect to a deferred compensation arrangement for a rabbi) continue to work as an effective way of securing deferred compensation promises.

When do the new rules take effect?

The new law takes effect on January 1, 2005 for amounts deferred on or after that date. Amounts deferred before that date will not be subject to the new rules, unless the plan is materially modified, in which case the new rules apply to all deferrals. If the new rules aren't met, income will not be deferred and a 20% penalty will be imposed in addition to income tax.

What should be done now?

First, employers should make an inventory of all deferred compensation arrangements. Then, a determination must be made as to which of those arrangements are subject to the new law. Those arrangements that are subject to the new law will have to be amended, and the changes must be communicated to all employees participating. The Treasury is required to issue guidance on the new law within 60 days, and this guidance might give additional time for compliance; but the process of reviewing these arrangements should begin now.

To obtain a more detailed memorandum on the new law, please send an e-mail to cbecker@saul.com or call Carol Becker at (215) 972-7705.

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.