Congress Approves Broad Changes to Nonqualified Deferred Compensation Arrangements — Enactment Imminent

Executive Compensation and Benefits Practice Team October 14, 2004

On October 11, 2004, Congress passed the American Job Creations Act of 2004 (the Act). The Act includes an amendment to the Internal Revenue Code of 1986 (the Code) that significantly alters the taxation of nonqualified deferred compensation arrangements and is expected to become law before the end of the year.

The Act adds new Section 409A to the Code, which provides for the inclusion in participants' gross income of amounts deferred under nonqualified deferred compensation plans that do not meet certain new Code requirements. Section 409A will be effective for amounts deferred after December 31, 2004. Unless the new requirements are met, amounts deferred under a nonqualified deferred compensation plan or arrangement on and after January 1, 2005 will be currently includible in income and subject to interest and tax penalties as of the date such amounts are no longer subject to a substantial risk of forfeiture. Amounts deferred prior to January 1, 2005 are generally not subject to the new requirements and tax treatment, provided that no material modifications to the pre-effective date deferred compensation arrangements are made after October 3, 2004.

Nonqualified Deferred Compensation Plan Broadly Defined

The definition of "nonqualified deferred compensation plan" in Section 409A is sweeping and includes any plan or arrangement that provides for the deferral of compensation, whether voluntary or not, other than a tax-qualified retirement plan or a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. The types of deferral arrangements covered include:

- Elective salary deferral arrangements;
- Elective annual and long-term bonus deferral arrangements;
- Supplemental executive retirement plans (SERPs);
- Excess plans (i.e., plans providing retirement benefits in excess of the limits imposed on tax-qualified retirement plans);
- Phantom stock plans;
- Restricted stock units;
- Stock appreciation rights (SARs);

- Section 457(f) "ineligible" deferred compensation plans of tax-exempt organizations and governmental units; and

- Deferred compensation plans for directors and other non-employees.

Tax-qualified retirement plans that are exempted from the requirements of Section 409A include Section 401(a) qualified retirement plans (including "401(k)" plans and pension plans), Section 457(b) "eligible" deferred compensation plans of tax-exempt organizations and governmental units, tax-deferred annuity plans and contracts described in Sections 403(a) and (b), simplified employee pensions (SEPs), SIMPLE IRAs and governmental excess benefit arrangements under Section 415(m).

According to the Conference Report, the grant of stock options taxable under Section 83 is not intended to be subject to Section 409A, provided that the option does not include a deferral feature other than the option holder's right to exercise the option in the future and the exercise price is not less than fair market value on the date of grant. Moreover, Section 409A is not intended to affect the taxation of incentive stock options meeting the requirements of Section 422 or options granted under an employee stock purchase plan meeting the requirements of Section 423. Section 409A also is not intended to apply to annual bonuses or other annual compensation paid within 2½ months after the close of the taxable year in which the relevant services were performed.

Requirements to Avoid Triggering Current Tax on Vested Amounts Deferred under a Nonqualified Deferred Compensation Plan

Section 409A significantly tightens the rules for deferral elections and distributions under nonqualified deferred compensation arrangements. All amounts deferred under a nonqualified deferred compensation plan after the effective date will be currently taxable to a participant (except to the extent the amount is subject to a substantial risk of forfeiture) unless the following requirements are satisfied:[1]

- ***Initial Deferral Election.*** The initial deferral election, if applicable, must be made no later than the close of the calendar year preceding the calendar year in which the participant performs the services giving rise to the compensation to be deferred. In the first year of participation, the election may be made within 30 days after the date the participant first becomes eligible under the plan. For performance-based compensation based on services performed over a period of at least 12 months, the election may be made no later than 6 months before the end of the performance period. The time and form of distribution must be specified at the time of the initial deferral.

[1] Unlike the original versions of the Act that were passed by the House and Senate, the Conference agreement provides that current taxation under Section 409A will apply only with respect to those participants with respect to which a failure to meet the Section 409A requirements has occurred.

Comment: Many plans currently permit deferral elections to be made during the calendar year in which the services are performed. Unless the limited exception for performance-based plans applies, these election procedures will have to be changed for future deferrals.

- ***Subsequent Deferral Election.*** If the plan permits a subsequent election to delay payment or change the form of payment, the election cannot take effect until at least 12 months after the date of the election. Except in the case of elections relating to distributions on death, disability or unforeseeable emergency, the first payment with respect to which the election is made must be deferred for at least 5 years from the date payment would otherwise have been made under the initial election. An election related to a distribution scheduled to be made at a specified time may not be made less than 12 months prior to the date of the first scheduled payment.

  Comment: Plans will have to be reviewed to determine which subsequent election features need to be changed.

- ***Restrictions on Distributions.*** The plan must provide that compensation deferred may not be distributed earlier than:

  - Separation from service, as determined under Treasury regulations, subject to a 6-month post-termination waiting period for certain key employees[2] of public companies (waived in the event the key employee dies prior to the end of the waiting period);
  - Disability;
  - Death;
  - A specific time (or pursuant to a fixed schedule) specified under the plan at the time of the initial deferral election (multiple payout dates and different forms of payment for different permissible distributable events are permissible);
  - Upon a change in ownership or effective control of a corporation, or in the ownership of a substantial portion of the corporation's assets, to the extent provided in Treasury regulations;
  - The occurrence of an unforeseeable emergency (i.e., a severe financial hardship to the participant). The amount of the distribution must be limited to the amount needed to satisfy the emergency and may include amounts needed to pay resulting taxes.

[2] "Key employee" is defined similarly to a key employee under a Section 416 top-heavy plan and generally includes officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

Comment: Elections keyed to separation from service or the attainment of a certain age will still be permitted, but elections keyed to a specific event (e.g., a dependent's enrollment in college) will not. Elections keyed solely to the timing of a distribution under a tax-qualified plan also appear to be prohibited, unless relief is provided under future Treasury regulations. Note, for key employees of public companies, the earliest date of a distribution keyed to retirement or other separation from service would be six months after such date.

Comment: The restrictive distribution provisions apply not only to future elective deferrals of compensation but also to future non-elective deferrals, including distributions under SERPs and excess benefit plans.

- ***No acceleration of payments.*** The plan cannot permit the acceleration of distributions, except as otherwise provided in Treasury regulations. The Conference Report states that future Treasury regulations should provide that the rule against acceleration will not be violated merely because a plan provides a choice between different forms of actuarially equivalent life annuity payments, or between cash and taxable property if the timing and amount of income inclusion is the same for each form of distribution. Also, the Conference Report states that Treasury regulations should provide other limited exceptions to the non-acceleration rule where, for example, accelerated distributions are required for reasons beyond the control of the participant and the distribution is not elective (e.g., court-approved settlements incident to divorce) or for automatic cash-outs of small amounts upon the occurrence of a distributable event (e.g., automatic cash-out of balances less than $10,000 upon separation from service, regardless of a participant's distribution election).[3]

  Comment: "Haircuts" (where a participant's distribution is reduced by a specified percentage if he or she elects an accelerated distribution) will no longer be allowed. Also, a participant generally will no longer be allowed to change the form of distribution from installments to a lump sum, except as provided may be permitted in future Treasury regulations.

Penalties

If nonqualified deferred compensation is payable under a plan or arrangement that violates any of the above requirements, all vested deferrals under the plan with respect to the participant to whom the violation relates will be currently taxable and subject to a penalty. Interest is imposed at the underpayment rate plus 1% on the underpayment of income tax that would have occurred had the amount been taxable when first deferred or, if later, when the amount was no longer subject to a

[3] Automatic cash-outs to key employees of public companies would be subject to the 6-month waiting period on post-termination distributions discussed above.

substantial risk of forfeiture. In addition, a 20% penalty tax applies to amounts required to be included in income.

Offshore Trusts and Funding

Contributions of assets to an offshore trust for the purpose of paying nonqualified deferred compensation will be treated as taxable transfers of property under Section 83 of the Code, even if the assets are subject to the general claims of creditors. Earnings on these assets will be treated as additional transfers of property. There is an exception for assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in that foreign jurisdiction.

Comment: It is customary in a number of foreign jurisdictions to utilize offshore trusts to fund certain retirement programs. To the extent a participant in such a program is subject to U.S. taxes, he or she may be taxed on any deferrals funded through the offshore trust unless relief is provided under future Treasury regulations.

A taxable transfer of property under Section 83 will also be deemed to occur if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. Assets will be treated as restricted even if the assets are available to satisfy the general claims of creditors. For example, the provision applies where a plan provides that upon a change in the employer's financial health, assets will be transferred to a trust. This provision is not intended to apply when assets are restricted to the payment of nonqualified deferred compensation upon a change in control, or if assets are periodically restricted under a structured schedule and the restriction coincides with a change in the employer's financial health.

The underpayment interest and 20% penalty tax described above under *Penalties* will apply to any offshore funding or restrictions of assets that are treated as taxable transfers of property under these provisions. Additional taxable transfers of property are deemed to occur each year there are earnings or appreciation in value of assets that have been contributed to offshore trusts or restricted upon a change in employer financial health.

Reporting Requirements

Amounts required to be included in income are subject to reporting on Form W-2 (or Form 1099) and tax withholding. Employers will also be required to report amounts deferred on Form W-2 (or Form 1099 in the case of non-employees) for the year deferred, even if the amount is not currently includible in income for that year. Treasury regulations may be issued establishing a minimum amount of deferrals below which reporting is not required. Regulations may also provide that the reporting requirement doesn't apply to amounts of deferrals in non-account balance plans that are not reasonably ascertainable, similar to the exception under Treas. Reg. § 31.3121(v)(2)-1(e)(4).

The definition of "wages" in Section 3401(a) for purposes of income tax withholding is amended to include any amount includible in the gross income of an employee under Section 409A, and the

payment of such amount will be treated as having been made in the taxable year in which the amount is includible. Thus, income tax will have to be withheld from salary or other wages to cover this liability.

Controlled Group Rules

The "controlled group" rules in Section 414, under which certain affiliated corporations and unincorporated businesses are treated as a single employer, will apply for purposes of the new deferred compensation provisions, except as otherwise provided in Treasury regulations. The Conference Report indicates that the controlled group rules should apply to a separation from service, such that the separation from service from one entity within a controlled group followed by continued service for another entity within the group should not be a permissible distribution event. It is also intended that the change in control of one member of a controlled group would not necessarily be a permissible distribution event under a plan of another member of the group.

Effective Dates

Section 409A is applicable to amounts deferred after December 31, 2004. An amount is considered deferred prior to January 1, 2005 if the amount is earned and vested prior to that date. Amounts deferred under an existing plan prior to January 1, 2005 will be subject to the new rules if the plan under which the deferral is made is materially modified after October 3, 2004. According to the Conference Report, the addition of a benefit, right or feature would be considered a material modification, while the exercise or reduction of an existing benefit, right or feature would not be a material modification. For example, material modifications would include the addition of a "haircut" provision or acceleration of vesting. Removal of a "haircut" provision or changing the plan administrator would not be treated as material modifications.

Subsequent deferrals of amounts initially deferred prior to January 1, 2005 under the terms of a prior plan or arrangement will not be subject to Section 409A, provided that the plan is not materially modified after October 3, 2004. These subsequent deferrals will be subject to the law that existed at the time of the initial deferral.

A transition rule requires Treasury regulations to be issued within 60 days after the date of enactment providing a limited period during which nonqualified deferred compensation plans adopted prior to December 31, 2004 may be amended to (i) allow a participant to terminate participation or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004 if such amounts are includible in the participant's income as earned (or, if later, when the amounts are no longer subject to a substantial risk of forfeiture) or (ii) conform the plan with Section 409A with respect to amounts deferred after December 31, 2004. The regulations may provide exceptions to certain requirements during the transition period, such as the timing of elections. It is also expected that the regulations will provide a reasonable time, during the transition period but after regulations are issued, for plans to be amended and approved by the appropriate parties.

Treasury Regulations

The Secretary of the Treasury is expected to promulgate regulations for carrying out the provisions of Section 409A, including regulations:

- Providing for the determination of the amount of a deferral in the case of a nonqualified defined benefit plan.

- Defining when a change in ownership or effective control of a corporation, or in the ownership of a substantial portion of the corporation's assets, occurs for the purpose of determining whether a distribution is permissible. Under the Act, guidance must be issued within 90 days after the date of enactment. According to the Conference Report, it is intended that a similar, but more restrictive, definition as is used for the golden parachute provisions of Section 280G will be adopted.

- Exempting arrangements from the application of the offshore trust rules if the arrangement will not result in an improper deferral of U.S. tax and will not result in assets being beyond the reach of creditors.

- Defining "employer's financial health" for the purposes of the asset restriction rules.

- Disregarding a substantial risk of forfeiture where necessary to carry out the purpose of the provision. The Conference Report provides that a substantial risk of forfeiture should not be used to manipulate the timing of income inclusion. For example, if a participant effectively controls the acceleration of the lapse of a substantial risk of forfeiture, the Treasury regulations should provide that income inclusion will not be postponed because of this restriction.

- Providing limited exceptions to the rule prohibiting the acceleration of the time or schedule of plan distributions.

- Providing for an alternate timeframe for the initial deferral election. For example, regulations could allow elections to defer bonuses earned over several years to be made after the beginning of the service period as long as the election is not made less than 12 months before the earliest initial distribution date of the bonus. Regulations may also consider when the amount of the bonus is determinable in determining the appropriate election period.

- Providing guidance regarding when an amount is deferred. The timing of an election to defer is not determinative of when the deferral is made.

- Defining "performance-based compensation" for purposes of the election rules. It is intended that the term will be defined to include compensation to the extent the amount is

(i) variable and contingent on the satisfaction of pre-established organizational or individual performance criteria and (ii) not readily ascertainable at the time of the election. The regulations may provide that performance-based compensation meet requirements similar to the requirements under Section 162(m). The Conference Report indicates, however, that the regulations need not incorporate all of the Section 162(m) requirements. For example, while the regulations may require that performance criteria be established within 90 days of the beginning of the service period, they need not require that such criteria be established in writing by the compensation committee of the Board of Directors. Regulations are also expected to address the timing of elections where the employer's fiscal year is not the calendar year.

- Providing guidance regarding to what extent elections to change a stream of payments are permissible.

- Providing guidance with respect to elections for payments under non-elective, supplemental retirement plans.

- Providing rules for identifying the deferrals to which assets set aside are attributable where assets equal to less than the full amount of the deferrals are set aside.

- Establishing a minimum threshold for deferrals that must be reported on Form W-2.

- Providing guidance relating to SARs.

- Providing guidance on the application of employer controlled group rules.

Planning Issues Raised by the Act

- Deferred compensation elections generally will have to be made in the calendar year prior to the year in which the services are to be performed. This will be particularly awkward for companies with non-calendar fiscal years who allow deferrals of bonuses payable on a fiscal year basis. For example, elections will have to be made by December 31, 2004 to defer bonuses to be earned for a fiscal year beginning July 1, 2005 and ending June 30, 2006. Plan sponsors should review the expected Treasury guidance to determine if their plans can meet the special rules that permit later elections for deferrals of performance-based compensation.

- The distribution rules are restrictive. Haircut distribution provisions in salary deferral and bonus plans are no longer permitted. Unless relief is provided under future Treasury regulations, SERPs and excess benefit plans will no longer be able to tie commencement of payments to the commencement of payments under the related qualified plan because that is not necessarily a distributable event. SERPs and excess benefit plans can, however, provide for distribution at a specified age or at separation from service (subject to a six-

month delay for certain key employees of publicly traded companies). As a plan termination is not a distributable event, employers will need to consider the impact of the rules on their ability to terminate plans if termination would trigger immediate distributions.

- Decisions must be made as to whether to grandfather existing deferrals or amend deferrals to comply with the new requirements. For administrative convenience, it may be desirable to have all deferrals under a plan subject to the same distribution rules and elections. The amendment provisions of some plans, however, may restrict the plan sponsor's ability to unilaterally amend existing deferrals. Any material amendments to an existing deferral after October 3, 2004 will cause the deferral to become subject to the new requirements. Unless Treasury regulations provide otherwise, participants should not be given the choice of having their prior deferrals grandfathered under the old rules or amended to comply with the new rules, as the offering of such choice might be considered a material modification that will trigger application of the new rules to all participants who are given the choice, whether or not they actually chose to be subject to the new rules.

- Elections that have already been made to defer compensation that will be earned or become vested after December 31, 2004 must be reviewed to determine if the deferral will comply with the new requirements. If an existing deferral to defer post-December 31, 2004 compensation does not comply with the new requirements, the deferral election must be either voided or amended to comply. As Treasury regulations providing guidance on the termination or amendment of existing elections are not required to be promulgated until 60 days after the Act becomes law, it is possible that such regulations will not be available before the end of the year. Thus, plan sponsors may have to act before regulations are issued to address outstanding deferral elections that take effect on or after January 1, 2005.

- Unless the Treasury regulations provide specific relief, the new election rules will eliminate the tax timing flexibility of SARs, since the election rules would require participants to designate the exercise date prior to the year of initial grant.

- "Mirror" plans, which provide for spillover contributions once a limit is reached in the underlying qualified plan, will become more complicated and will need amendments to comply with the new provision. For example, typically when a deferral rate in the 401(k) plan is changed, the same change occurs in the mirror plan. This will no longer be permissible since the timing rules require the elections in the mirror plan to be made in the prior year.

Additional Information

If you wish to obtain more information on the ramifications of the nonqualified deferred compensation rules on your plans, please contact one of the members of the Pillsbury Winthrop executive compensation and benefits team. Questions regarding this alert may be directed to Susan P. Serota (212-858-1125 or *sserota@pillsburywinthrop.com*) or Peter J. Hunt (212-858-1139 or *phunt@pillsburywinthrop.com*) in New York, Glenn Borromeo in San Francisco (415-983-1733 or *gborromeo@pillsburywinthrop.com*), Cindy V. Schlaefer in Silicon Valley (650-233-4023 or *cschlaefer@pillsburywinthrop.com*), and Jan H. Webster in Carmel Valley (858-509-4012 or *jwebster@pillsburywinthrop.com*).

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