Nonqualified Deferred Comp Law Finally Adopted as new IRC § 409A

After years of deliberation and competing legislative proposals, Congress has enacted new deferred compensation rules that will have an immediate impact on virtually all deferred compensation plans and arrangements.

On October 22, 2004, the President signed into law sweeping new tax legislation, the American Jobs Creation Act of 2004. Among many other significant changes, the statute adopts a new section in the Internal Revenue Code (IRC) governing nonqualified deferred compensation – Section 409A. This new section will impose restrictions on a broad array of deferred compensation arrangements, with substantial penalties for non-compliance. While many of the provisions of Section 409A will be familiar to those who have been following the legislative process in recent years (see, e.g., Deferral.com Legal Update (August 2003)), many – indeed most – deferred compensation plans are likely to run afoul of the new restrictions. Penalties on participants for non-compliance are severe (20% surtax, plus interest at one percent over the underpayment interest rate, measured from when the income was deferred).

The new restrictions apply to three areas:

- **Distributions** – only six types of distributions are permitted, and no acceleration of distributions is allowed -- no more “hair cut” provisions for accelerated payments;
- **Elections** – permissible times to make deferral elections have been clarified and narrowed, with changes in distribution elections being heavily restricted; and
- **Funding Arrangements** – setting up off-shore rabbi trusts and the creation of trusts or restrictions intended to protect funding assets upon changes in an employer’s financial health (even if tied to a future contingency and without removing assets from the reach of creditors) will be treated as taxable transfers of property to the participant.

Amounts deferred for services performed after December 31, 2004 will be governed by the new rules, even under plans that existed before the legislation. Deferrals for earlier periods that have vested before December 31, 2004 will be excluded, but this grandfathering is lost if the applicable plans have been “materially modified” after October 3, 2004. Earnings (both actual and notional) on deferrals that are subject to the new rules will be treated and taxed on the same basis as the deferred amounts on which they are earned. Reporting of deferred income also will be required on form W-2 or 1099-Misc. More detailed transition regulations (including a limited grace period to unwind or conform existing elections) are due out within 60 days of enactment.

What Types of Plans are Covered?

The new section will apply to any nonqualified arrangement (broadly defined) that provides for the deferral of compensation, even contracts affecting individual employees. A number of equity incentive arrangements are covered, as well.

Plans affected by the new legislation include traditional nonqualified deferral plans (including 401(k) mirror or wrap-around plans), bonus deferral plans, supplemental executive retirement...
plans, stock appreciation rights, phantom stock plans and stock options granted with below-market exercise prices. While the exact scope of the legislation’s reach will not be certain until after regulations are issued, it is possible that restricted stock and restricted stock unit plans also could be impacted.

The only plans generally excluded are (i) qualified profit sharing and pension plans, along with certain other “qualified employer plans” spelled out in the section, and (ii) bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans. Limited exceptions also exist for bonuses paid within 2½ months after year end, § 422 incentive stock options, § 423 employee stock purchase plans and certain non-employee arrangements for tax exempt entities under § 457(e)(12).

In short, the new section’s scope is very broad, and each employer should review its plans and employment contracts carefully with an eye for potential compliance issues.

**What are the Penalties for Noncompliance?**

Failing to comply with the new rules requires participants to include the deferred compensation in taxable income, and imposes a 20% penalty tax and interest at the underpayment rate plus one percent. Compliance is tested on the participant level, so failure to comply in the case of one participant will not torpedo the entire plan. On the other hand, non-compliance generally will make deferrals taxable from the original time of service, unless subject to a substantial risk of forfeiture. Substantial risk of forfeiture is defined in the Act to mean a participant’s right to compensation is “conditioned upon the future performance of substantial services by any individual.”

**What Distributions are Permitted?**

Plans under the Act may only be used for six types of distributions:

- **Separation from service;**
- **Disability,** limited by definition to disability expected to result in death or to last for a continuous period of at least 12 months (or receipt of disability insurance for either of the foregoing reasons for a period of not less than 3 months);
- **Death;**
- **Specified time or schedule,** which must be calendar driven (basing distributions on the timing of a future event or contingency, such as a child’s education, is no longer permitted);
- **Change in ownership or control;** and
- **Unforeseeable emergencies,** but only to extent of severe financial hardships to a participant that result from accident or illness of the participant, the participant’s spouse or a dependent, casualty losses and “other similar extraordinary and unforeseeable circumstances” beyond the participant’s control required for the emergency, and then only to extent not funded by insurance or other means, plus taxes that would apply to the distribution amount.

Distributions for separation from service and for changes in ownership or control will be subject to regulations to be adopted within 90 days after enactment.
A special rule applies to certain key employees of public companies – A plan may not permit separation of service distributions to be made to such participants until at least six months after their separation from service has occurred. This special rule applies to senior officers who make $130,000 or more annually (limited to the top 3 such officers or, if greater (up to a maximum of 50), the top 10%); 1 percent owners whose compensation is $150,000 or more annually; and 5 percent owners regardless of their compensation.

**Can distributions be accelerated?**

The widely-used “hair cut” provision, where a participant is permitted to take an early distribution by incurring a significant penalty (typically 10%), no longer is allowed. Section 409A will prohibit changes in the time or schedule of distributions, with very limited exceptions under regulations yet to be adopted:

- Permitting participants to choose between cash and taxable property (such as fully taxable annuities) should be allowed, if the timing of income inclusion for tax purposes is not affected;
- The Congressional Report encourages adoption of regulations that would allow choices between different forms of actuarially equivalent life annuity payments; and
- Regulations are expected to be issued that would allow for accelerated distributions that are non-elective and required for reasons beyond the participant’s control, such as federal conflict of interest requirements, court-approved divorce settlements, etc.

**How are Elections Restricted?**

Deferral Elections normally must be made during the year preceding the taxable year in which the applicable services are performed. Two special rules soften this in certain cases:

- **New participants** may make elections within the first 30 days after they first become eligible to participate under a plan; and
- **Elections to defer performance-based compensation** may be made not later than 6 months before the end of the performance period, provided that the performance period is at least 12 months in duration. Based on comments in the Congressional Report, performance plans will likely need to be finalized and documented in writing within the first 90 days of the taxable year, and will need to contain performance standards that are meaningful and readily ascertainable at the time the election is made (no “slam dunks” allowed).

**Can distribution elections be changed?**

The new legislation substantially restricts changes in elections affecting the form or timing of distributions:

- Elections to change the schedule or form of a distribution cannot affect any distribution until at least 12 months after the change election is made (no last minute postponements); and
- **Except for distributions for death, disability or unforeseeable emergencies (as narrowly defined in the Act), any change must postpone a distribution by at least five years** from its originally scheduled payment date. In effect, the wording of this rule means that
changes to any distribution that is based on separation from service, a specified schedule or a change in control must postpone the payment by a full five years or more.

- In the case of scheduled payment elections, a further restriction is imposed – the **schedule may not be changed after 12 months before the first scheduled distribution**. In effect, this **locks in** the original schedule once you have come within a year of when the payment stream commences. Limited exceptions may be allowed in future regulations.

**What restrictions are imposed on funding arrangements?**

First, it is important to note that the new legislation does **not** create safe harbors for any funding arrangement of a nonqualified plan. The existing doctrines of constructive receipt, economic benefit and assignment of income will continue to apply to nonqualified deferral arrangements. The new funding rules are intended to clamp down on what previously (albeit controversially) had been considered permissible employer funding practices under the existing doctrines:

- **Offshore rabbi trust arrangements**, in which corporate assets intended to fund plan liabilities were left open to claims of an employer’s creditors, but were housed off-shore, thus making the assets harder for creditors to reach in practical terms, which arguably undermined the limits of what was intended under rabbi trust rulings (limited exceptions exist for rabbi trusts set up in foreign jurisdictions where substantially all of an employee’s services, to which compensation relates, are performed); and

- **Employer financial health restrictions**, in which assets become restricted in connection with a change of an employer’s financial condition.

Section 409A will impose a 20% penalty tax and underpayment interest as soon as either of the foregoing arrangements occurs (or, in the case of financial health restrictions, as soon as the plan contains a provision that would allow such restrictions to arise), provided that the compensation in question is not subject to a substantial risk of forfeiture.

**Does the Act impose new reporting or withholding requirements?**

Yes. With limited **de minimus** exceptions (to be established by regulation), amounts deferred will have to be reported on a participant’s W-2 or 1099-Misc. Amounts included in taxable income under Section 409A will be subject to withholding.

**When does the Act become effective, and to what deferrals?**

Section 409A was approved as part of the sweeping American Jobs Creation Act of 2004 (H.R. 4520), approved by the House on October 7 following a Joint Conference Report (H. Rept. 108-755) on the same date, and approved by the Senate on October 11, 2004. The Act became effective when signed by the President on October 22, 2004.

In most cases, amounts deferred for services performed, or that vest, after December 31, 2004, will be subject to the new rules of § 409A, but if a plan has been materially modified after October 3, 2004, pre-existing deferrals also will become subject to § 409A’s new rules and penalties.
What is a Material Modification to a Plan?

According to the Joint Conference Report that accompanied the final legislation, the “addition of any benefit, right or feature is a material modification” (for example, accelerating vesting or adding a “haircut” distribution right), while the “exercise or reduction of an existing benefit, right or feature” is not (for example, changing a plan administrator or removing a previously existing “haircut” distribution right). The IRS is expected to issue guidance on plan amendments within 60 days after the statute’s enactment (i.e., by December 22, 2004), on how plans may be amended and on how existing elections for post-December, 31, 2004 deferrals may be unwound or conformed. Given that grandfathering of existing deferrals can be lost upon plan modification, employers may be wise not to adopt plan amendments until after IRS transition guidance has been published.

What do we do while waiting for the IRS transition regulations?

First, it is imperative that all plans, contracts and arrangements be inventoried to determine which include nonqualified deferred compensation arrangements. Beyond the obvious types of nonqualified defined contribution plans currently supported by Deferral.com, many employment agreements, certain equity incentive plans, nonqualified defined benefit plans, etc. are likely to be affected. An employer should identify all plans and arrangements that may be subject to this important legislation.

What do we do about elections for 2005?

Until the IRS transition regulations are published, this is challenging, to say the least. The legislation calls for Treasury regulations to be promulgated within 60 days after enactment. With an enactment date of October 22, that suggests we should see at least preliminary regulations by mid to late December (assuming the IRS meets the deadline). Modifying plans now could be dangerous, since material modifications after October 3, 2004 can jeopardize grandfathering of pre-2005 deferrals, although the Joint Conference Report indicates that reductions in rights or features should not be treated as material modifications for the grandfathering clause (see above).

It would seem to make little sense to allow executives to make elections now that would fail under the new rules, although transition regulations are expected to allow executives to opt out of and, perhaps, conform, such defective elections for a limited transition period without penalty. Some advisers have suggested setting up new plans now that, at a minimum, take existing plans and strip out offending provisions under the new rules, such as haircut distributions. Needless to say, a plan sponsor would be well advised to work carefully with its consultants, counsel and other professionals.

Did the Act include the Senate’s earlier proposal to restrict investment alternatives to those offered by an employer in its least favorable qualified plan?

No. This controversial provision of the Senate version of the bill had raised numerous questions, including whether and how an employer could use variable life insurance as a funding mechanism for nonqualified plans (since qualified plans could use similar, but not identical, fund offerings). This provision, among others, was eliminated during the Joint Conference.
Where can I find out more about this important legislation?

Many tax and other professionals practicing in the specialized area of nonqualified and executive benefits are publishing useful summaries of the new law. One excellent resource that is readily available to the public is Congress’ Joint Conference Report, H. Rept. 108-755 (Oct. 7, 2004), which is available online at Congress’ “Thomas” web site (thomas.loc.gov). You can find the report by running a search on the Thomas site under the original bill number, “H.R. 4520”. The Conference Report is an excellent resource not only on new IRC Section 409A, but on the many other amendments approved in the American Jobs Creation Act of 2004 (H.R. 4520), as well.

Regulations under § 409A should be forthcoming shortly. Assuming the IRS follows the timeline contemplated in the Act, regulations providing a transition period for conforming amendments and to unwind non-conforming elections should be released by December 22, 2004. It is hoped that these transition regulations will include clarification on how to handle existing deferrals that have not yet vested. Regulations defining a change in control for purposes of the statute are due within 90 days of enactment. Additional regulatory guidance from the IRS is expected (and needed) on a number of other important matters, including further clarification of what plans are covered, when deferrals will be deemed to have been made, what constitutes separation from service as a permissible distribution event, what is “financial health” for purposes of the protective funding restrictions, limited exceptions for non-elective accelerations of distributions, employer aggregation rules, how to determine deferral amounts for defined benefit plans, limits on the use of substantial risk of forfeiture as a timing mechanism, etc.

For more information, please contact:

Joe Hutcheson, J.D., M.B.A., President
Deferral.com, Inc.
9 Riverside Office Park
Weston, MA 02493
Tel: (781) 891-9693
Fax: (781) 647-8701
E-mail: info@deferral.com