GOULD & RATNER

New Tax Rules for Deferred Compensation

By David Arnburg, Partner

The American Jobs Creation Act of 2004 imposes new strict requirements on nonqualified deferred compensation arrangements. New Section 409A of the Internal Revenue Code governs elections to defer compensation, payment of deferred compensation, and methods of funding deferred compensation. Section 409A also requires that its rules be reflected in written plan documents. Failure to comply with these new requirements in the plan documents or in operation of the plan will result in immediate taxation of deferred compensation not subject to substantial risk of forfeiture at normal income tax rates plus a penalty of 20% of the deferred amounts. In addition, interest at the underpayment rate plus 1% will be assessed from the date the deferred compensation was first earned and vested.

What Compensation is Subject to the New Rules?

The new rules apply to arrangement, contract, method or agreement providing for deferral of compensation other than (i) qualified retirement plans, IRAs, SEPs, Section 457(b) plans, and tax deferred annuities and (ii) welfare benefit plans providing bona fide vacation leave, sick leave, compensatory time, disability leave, and death benefits. With certain exceptions, compensation is deferred if the service provider (e.g. employee) has a legally binding right during a taxable year to compensation that has not been actually or constructively received and such compensation is payable in a later year.

What Types of Plans Are Covered by the New Rules?

The new rules cover plans for one employee (including employment agreements), for multiple employees and for independent contractors (such as consultants and directors). Bonus plans, management incentive plans, supplemental employee retirement plans (SERP), certain stock appreciation rights plans (SAR), phantom stock plans, restricted stock unit plans, economic value added plans, and certain severance pay plans are examples of plans subject to the new rules.

What Requirements Govern Deferral Elections?

Generally, elections to defer compensation must be made before the calendar year in which the compensation is earned. However, performance based plans may permit elections to be made up to the last 6 months of the performance period and new participants may make an election within 30 days after commencing participation. Further, a participant may elect to change the time or form of payment only if (i) the change extends the deferral of the first payment by at least 5 years unless the change is elected in connection with death, disability or unforeseeable emergency, (ii) for a change in a payment to be made at a specified date, the change is elected at least 12 months prior to the first scheduled payment and (iii) the change will not take effect for at least 12 months after the date the change is made. No change can result in an "acceleration of benefits," a phrase very broadly defined in the relevant guidance.

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What are the Restrictions on Distributions?

Distributions of deferred compensation may only be made on death, disability (as defined in Section 409A), a date specified or schedule fixed at the time of deferral (not tied to occurrence of an event), separation of service with all members of the same controlled group, change of control/sale of assets of a corporation only, or unforeseeable emergency (limited to the amount necessary to satisfy the emergency).

What are the Restrictions on Funding?

Employers may still utilize "rabbi trusts" to set aside monies to pay deferred compensation but use of offshore trusts and funding of deferred compensation triggered by a change in the financial health of the employer are prohibited.

Conclusion

The new requirements are effective January 1, 2005 subject to certain grandfather and transition rules. All plans and arrangements, including employment agreements providing deferred compensation, should be reviewed and revised, if necessary, to comply with Code Section 409A. Employers may also want to notify employees, directors and consultants of the new law and potential changes to their deferred compensation arrangements.

Gould & Ratner has dealt with the impact of Code Section 409A in a variety of circumstances. We would be happy to answer any questions you may have about its effect on your situation. *If you have any questions about any issues raised in this article, please contact David Arnburg at darnburg@gouldratner.com, or call 312/899-1600.*

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