

## The Impact of the American Jobs Creation Act of 2004 on Nonqualified Deferred Compensation Plans

After years of considering proposed deferred compensation legislation, Congress included new nonqualified deferred compensation (“NQDC”) plan rules in the American Jobs Creation Act of 2004 (H.R. 4520) (the “Act”). The Act, which the President is expected to sign, was passed by Congress on October 11, 2004. The new NQDC plan rules included in the Act are very broad in scope and require all employers (including public, private, tax-exempt and governmental) to take immediate action with respect to their deferred compensation plans and/or programs.

The Act adds section 409A to the Internal Revenue Code (“Code”), which applies to amounts “deferred” (generally, earned and vested) after 2004. Section 409A adds specific rules for deferral elections, distributions and funding mechanisms under NQDC plans.

### New Definition of NQDC Plans or Arrangements

New section 409A defines a “nonqualified deferred compensation plan” as any plan that provides for the deferral of compensation, except as otherwise set forth below. The definition of an NQDC plan is not limited to elective arrangements, but also covers nonqualified defined benefit plans (*i.e.*, SERPs). Also covered is any plan, arrangement or agreement to defer compensation, including those covering only one person or non-employees.

The definition of an NQDC plan specifically excludes the following:

- tax-qualified plans, tax-deferred annuities, 457(b) plans, SEPs, SIMPLEs, and qualified governmental excess benefit arrangements under Code section 415(m);
- plans of governmental entities and tax-exempt organizations that are exempt from Code section 457 under Code section 457(e)(12) and meet certain other requirements, and
- any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

In addition, the new rules of Code section 409A do not apply to annual bonuses or other annual compensation that is paid within two and a half months after the close of the year in which the bonus or compensation is earned. However, until the IRS issues further guidance, severance plans would appear to be subject to the new rules.

## Equity Compensation Plans Considered to be NQDC Plans

Equity compensation plans that provide for the deferral of compensation are subject to the new rules. The Act exempts nonqualified stock options that are issued with an exercise price which, as of the date of grant, is equal to the fair market value of the stock, incentive stock options and employee stock purchase plans that do not contain a deferral feature. However, the Conference Report states that stock appreciation rights (“SARs”) are covered by the Act, and also states that the IRS may address issues related to SARs in future guidance. Restricted stock and restricted stock units are not addressed in the Act or the Conference Report, so their status may be determined by IRS regulations.

### The New Rules

The following is a brief summary of some of the key provisions of the Act’s new NQDC plan rules.

***Distribution Restrictions:*** Distributions under NQDC plans are now limited by new rules which state that distributions may be made only under the following circumstances: (1) separation from service; (2) disability (as defined in the Act); (3) death; (4) an unforeseeable emergency (to the extent necessary to meet such emergency); (5) a specified time or pursuant to a fixed schedule specified under the plan at the date of deferral; or (6) a change in the ownership or effective control (or in the ownership of a substantial portion of the assets) of a corporation.

Key employees of publicly traded corporations are not permitted to receive a distribution earlier than six months after separation for service.

Popular features such as distributions upon a future event (*e.g.*, a child entering college) are no longer allowed.

***Acceleration of Payments:*** The time or schedule of any payment may not be accelerated, except as may be permitted in soon-to-be-issued guidance. Provisions that allow a participant to receive an immediate payout, subject to forfeiture of a percentage (usually 10 percent) of the amount distributed (known as a “haircut” provision), would be eliminated as a result.

***Initial Elections:*** Deferral elections generally must be made no later than the close of the year prior to the year during which the services giving rise to the compensation are performed. Newly eligible participants may, however, elect within 30 days of eligibility to defer future compensation; and for performance-based compensation earned over a period of at least 12 months, elections may be made up to six months before the end of the performance period.

***Subsequent Elections – Changes in Time or Form of Distribution:*** Subsequent elections to further defer distribution are permitted, but must be made at least 12 months before such amounts would have been received and must require that such amounts be deferred for at least five years from that date.

***Offshore Trusts:*** Subject to limited exceptions, assets set aside in an offshore trust, even if the trust is a “rabbi trust” subject to the claims of creditors of the employer, are treated as subject to Code section 83 and, therefore, are taxable when vested.

**Financial Health Triggers:** The Act prohibits the use of rabbi trusts with financial health of the company provisions (also known as “springing rabbi trusts”). A springing rabbi trust is one which provides that, in the event of a financial health trigger, the trust assets will no longer be subject to the reach of the company’s creditors. Rabbi trusts or NQDC plans with such “springing” terms will result in NQDC plan deferrals becoming immediately taxable.

## **Tax Reporting**

Under the Act, amounts deferred must be reported on IRS Form W-2 or 1099 for the year of the deferral, even if the amount is not included in the individual’s income for that year. As a practical matter, deferrals that comply with Code section 409A will normally be reported twice – once in the year of deferral and again in the year paid. This new reporting requirement will allow the IRS to identify employers and NQDC plans for audit.

## **Effective Date and Grandfathering of Existing Deferred Compensation**

The Act applies to amounts deferred in 2005 or later and generally does not apply to amounts deferred in 2004 or earlier. For this purpose, “deferred” means both earned and vested. As a result, only those deferred amounts that are vested will be grandfathered under prior law. In addition, if an NQDC plan is materially modified after October 3, 2004, the amounts previously deferred under the plan will be subject to and must comply with the new rules to avoid taxation. The Act directs the IRS to issue guidance within 60 days of final enactment providing, among other things, a limited transition period during which an NQDC plan adopted before December 31, 2004, may be brought into compliance with the new requirements with respect to amounts deferred after December 31, 2004. Accordingly, any NQDC plan changes currently under consideration need to be carefully reviewed before adoption.

## **Violation of the New Rules**

Failure to satisfy the new requirements either in form or in operation will result in: (1) the current inclusion in the individual’s income of all amounts deferred in the current and prior years; (2) the individual becoming liable for interest at the tax underpayment rate plus one percent from the date the included amount was first deferred or vested; and (3) an additional penalty tax equal to 20 percent of the amount included in the individual’s income.

## **Action Items for Employers to Consider**

- 1. Identify impacted plans** – In addition to typical elective deferral plans and defined benefit plans, the Act would affect certain types of equity compensation plans and other arrangements that include a deferral feature and that have not generally been considered deferred compensation plans.
- 2. Decide if changes are necessary to NQDC plans** – The following changes would need to be made to many NQDC plans:

“Haircut” withdrawal provisions need to be removed.

Elections as to timing and form of payment that are tied to elections under a qualified plan (often found in SERPs) may need to be revised.

Elections to defer performance-based compensation need to be made at least six months before an end of the relevant performance period.

Subsequent elections to defer payment of a scheduled distribution need to provide for an additional deferral period of at least five years from the originally scheduled payment date.

The ability of a participant to change the scheduled form of payment for a deferred amount from installments to a lump sum needs to be removed.

Payments to key employees of a public company upon separation from service need to be delayed for six months.

The definition of “disability” may need to be revised to conform with the definition of disability in the Act.

Duane Morris is presenting a series of workshops entitled “**The American Jobs Creation Act of 2004 and Its Impact on Nonqualified Deferred Compensation Plans.**” The firm’s Employee Benefits and Executive Compensation Group invites you to participate in this informal roundtable discussion on the recently passed Act and the challenges employers face in satisfying the Act’s rules that affect NQDC plans. For the first time, the Internal Revenue Code will provide specific rules for deferral elections, distributions and funding mechanisms under NQDC plans. Learn the specific steps that most plans must take before January 1, 2005, to avoid significant penalties.

Please see workshop schedules listed below:

#### **Philadelphia**

Wednesday, November 10, 2004

8:30 - 11:00 a.m.

Duane Morris LLP

One Liberty Place

39th Floor

Philadelphia, PA 19103

R.S.V.P. 215.979.1338

#### **New York**

Thursday, November 11, 2004

9:00 - 11:30 a.m.

Duane Morris LLP

380 Lexington Avenue

48th Floor

New York, NY 10168

R.S.V.P. 212.471.1855

**Chicago**

Tuesday, November 16, 2004

8:30 - 11:00 a.m.

Duane Morris LLP

227 West Monroe Street

Suite 3400

34th Floor

Chicago, IL 60606

R.S.V.P. 312.499.0122

For further information or to register for a workshop, visit our Web site at <http://www.duanemorris.com/events/event952.html>

Note: If these locations are not convenient for you, please e-mail Lisa Cardile at [lmcardile@duanemorris.com](mailto:lmcardile@duanemorris.com) for information about future workshop locations.

## **Duane Morris**

### **Employee Benefits and Executive Compensation Group**

Duane Morris' Employee Benefits and Executive Compensation Group provides timely information on the increasingly complex requirements of the myriad federal and state laws that govern this field. Our lawyers have extensive experience representing clients in all facets of benefits-related disputes. If you have any questions about the Alert or would like to learn more about the new NQDC plan rules, please contact one of the lawyers below or the lawyer in the firm with whom you are regularly in contact.

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