

Summary
Restrictions on Nonqualified Deferred Compensation
Conference Report on H.R. 4520

On October 6, 2004, House and Senate Conferees completed negotiations on export tax legislation (H.R. 4520) that includes significant new restrictions on nonqualified deferred compensation. Although there is still much uncertainty about how the provisions will work in practice, the following reflects our understanding based on the legislative language and the “Statement of Managers,” which explains the new provisions.

Definition of Nonqualified Deferred Compensation

The agreement adds a new section to the tax code, Section 409A, regulating nonqualified deferred compensation. It applies to all deferrals made after December 31, 2004 in all nonqualified deferred compensation plans, which are defined as any plan that provides for the deferral of compensation other than:

- a qualified employer plan (qualified retirement plan, tax deferred annuity, simplified employee pension and SIMPLE)
- a bona fide vacation, sick leave, compensatory time, disability pay or death benefit plan.

Stock Options Excluded. The statement of managers indicates that arrangements providing for the grant of nonqualified stock options at fair market value should not be included in the definition of nonqualified deferred compensation, provided that the arrangement “does not include a deferral feature” other than the fact that the option holder has the right to exercise the option at some point in the future. Incentive Stock options and options granted under an employee stock purchase plan are likewise excluded.

Regulatory Authority Given for SARs. Stock Appreciation Rights (SARs) are not mentioned in the Statement of Managers as carved out of the definition. However, Treasury is given the regulatory authority to “address issues relating to stock appreciation rights,” indicating that Treasury may exclude certain arrangements involving SARs.

Bonuses/Annual Compensation Paid After Close of Taxable Year. The definition does not include annual bonuses or other annual compensation that are paid (in cash) within 2 ½ months of the end of the taxable year in which the services were performed. The provisions would still cover deferrals of those amounts.

Elections to Defer Income

Under the conference agreement, the general rule is that elections must be made before the taxable year in which the income is earned or within 30 days in first year of eligibility.

Exception for Performance-Based Plans. If the plan provides for compensation based on performance over at least 12 months, the election to defer may be made up to 6 months before the end of the performance period. (*E.g.*, if the employer has a calendar year 12-month performance-based bonus plan, the election must be made before July 1).

Performance-based compensation will be defined to include compensation that is

- variable and contingent on the satisfaction of preestablished individual or organizational performance criteria; and
- not readily established at the time of the election.

Under the regulations, performance-based compensation may be required to meet some criteria that are similar but less comprehensive than that under section 162(m). For example preestablished criteria may be taken to mean established in writing within 90 days of the performance period, but no consideration by the compensation committee of the board of directors would be required. Treasury is expected to issue guidance providing rules regarding the timing of elections when the fiscal year of the employer and the taxable year of the individual are different.

Exceptions to the Election Rules During Transition. The election to defer does not constitute the actual deferral (the act of placing compensation in a deferred account). Thus, there is some confusion over how the agreement would affect elections made in 2004 for compensation to be deferred in 2005. Absent transition provisions, any election made after December 31, 2003 (or June 30, 2004, in the case of performance-based plans that are 12 months or longer) would violate the legislation. The Statement of Managers gives Treasury regulatory authority to provide exceptions to the rules regarding timing of the election for plans coming into compliance with the new rules. Thus, Treasury has the ability except deferral elections made during 2004 for bonus amounts earned in 2004 and to be deferred in 2005. It will not be known how flexible this criteria will be until regulations are issued. In addition, for the purposes of the transition to the new rules, all amounts that are earned and vested by December 31, 2004 will be considered deferred in 2004, even if not paid until 2005.

Timing of Distribution Set at Time of Initial Deferral. Under the conference report, a participant is required to specify when and how the deferred compensation will be paid at the time of initial deferral. At that time, however, the individual may elect different forms of distribution for different distribution events (*e.g.*, a lump sum upon disability, but an annuity at age 65).

Nonelective Supplemental Retirement Plans. In general, Supplemental Executive Retirement Plans are covered by the restrictions in the legislation. A key issue has been whether annual elections are required to defer and set the time for distribution for

amounts that are placed into the plan annually. The Statement of Managers indicates that Treasury is allowed to issue regulations regarding elections with respect to payments under nonelective supplemental retirement plans (*e.g.*, those that mirror qualified defined benefit plans). If such regulations are issued, they should at least minimize the necessity for annual elections and the excessive additional paperwork for these plans.

Subsequent Elections Limited. Subsequent elections to delay the time and form of payment not take effect for 12 months, and for payments following separation from service, made at a specified time or pursuant to a fixed schedule, or due to a change in ownership or control are limited to those made for a minimum of five years. If the subsequent election is made to a stream of payments, it must be made 12 months before the first payment is to be received.

Acceleration of Distributions. In general, no acceleration of deferred amounts is permitted, such as a change from an annuity to a lump sum. It is not anticipated that the rule against acceleration will be considered violated because the plan provides a choice between cash and taxable property if the timing and amount of income inclusion is identical. Treasury is given regulatory authority to make limited clarifications and exceptions. Treasury is expected to provide rules permitting a choice between actuarially equivalent forms of life annuity payments. Treasury is also expected to permit the payment of the employee's share of withholding taxes from the employee's interest in the nonqualified deferred compensation plan. This may occur in the case of separation from service for a key employee, where payment of the deferred compensation is delayed for six months, but the income is recognized upon separation. Treasury is expected to provide that automatic distributions of minimal interests in a plan following a permissible distribution event (*e.g.*, separation from service) is permissible for administrative convenience.

Treasury Regulations. Treasury is expected to draft regulations providing limited exceptions to the general rule on elections, such as an election to change a stream of payments is permissible.

Permissible Distributions

The conference agreement limits permissible distributions to

- death;
- disability;
- specified time set on date of deferral or under the plan;
- separation from service, as defined by Treasury, but for the top 50 executive officers earning over \$130,000, distribution must occur at least 6 months after separation date.
- change in ownership or effective control, as defined by Treasury, under a more restrictive definition than set for golden parachute payments.

Rabbi Trust Provisions

The agreement imposes limitations on the use of offshore rabbi trusts and those funded following a change in the employer's financial health.

Offshore Rabbi Trusts. Rabbi trusts in which the assets are located outside of the U.S. are taxable when the assets are set aside or when they are subsequently transferred outside of the country. There is an exception for offshore rabbi trusts in jurisdictions where most of the compensation was earned (such as for expatriates) or if the trust would not violate the intent of the restrictions.

Springing Rabbi Trusts Due to Change in Employer's Financial Health. Rabbi trusts that provide for "funding" in the event of a change in the employer's financial health are taxable on the date when the assets are first restricted due to a decline in the employer's financial health or the date on which the plan states that such assets will be restricted. In addition, the restriction of deferred assets to a rabbi trust in the event of a change in the employer's financial health, even if the trust is subject to general creditors' claims, is likewise prohibited and all amounts deferred are taxable. Restrictions of assets for other purposes (such as change in control) or those set aside on a regular schedule that happen to coincide with a decline in financial health are not covered by this provision. The term "financial health is to be defined in Treasury Regulations.

Penalties

If the plan is violated, the violation applies only to the individual with respect to whom the plan is violated. The individual is liable for

- back taxes;
- interest at a rate 1 percent higher than typical tax penalties;
- 20 percent additional penalty.

Effective Date

The agreement applies to any deferrals made after December 31, 2004. However, for the purposes of the effective date, an amount that is earned and vested by that date is considered deferred before that date.

Grandfather for Amounts Deferred Prior to December 31, 2004. The agreement provides that amounts deferred in existing plans prior to December 31, 2004 are grandfathered under the terms of the existing plan, provided the plan was not materially modified after October 3, 2004 to make it easier to control the funds the plan. A material modification means a change that makes it easier for the participant to control income, such as the addition of a haircut provision. This provision does not permit the deferral of new amounts into the plan after December 31, 2004. The Statement of Managers directs the IRS to challenge pre-December 31, 2004 deferrals that violate current law.

Transition Rules. Treasury is expected to craft guidance allowing employers to terminate and revise their plans to conform to the legislation without triggering a violation of the legislation. The Statement of Managers indicates that transition rules should allow employers to amend their plans to give participants the ability to terminate participation in the plan or cancel an outstanding deferral election for amounts to be deferred after December 31, 2004 without penalty under the new rules. However, the participant is required to take the amounts into income as earned and pay income taxes on it. The transition rules also allow employers to amend their plans to conform to the new requirements without triggering a violation. Treasury is directed to give employers a reasonable time after its guidance is issued to allow the amendment and approval of plans.

Aggregation Rules

Employer aggregation rules apply for the purposes of determining when a permissible distribution event occurs. For example, if a permissible distribution event occurs with respect to one entity in a controlled group, such as a change in control, the event would not result in a permissible distribution of deferred compensation for those employed by another controlled group.

Treasury Regulations

Treasury is authorized to draft regulations as necessary to implement the legislation. It is directed to craft guidance on the following issued within the time frames indicated:

- general transition rules (60 days after enactment);
- definition of change in ownership or effective control (90 days after enactment);
- determination of amounts of deferral for nonqualified defined benefit plans);
- implementing the provision relating to distributions that result from a change in ownership or effective control;
- defining financial health for purposes of the rabbi trust prohibitions.

Reporting Requirements

The agreement requires employers to report to the IRS on form W-2 deferred compensation included in income for the taxable year, as well as income that has been deferred. The latter is intended to help the IRS target its auditing efforts to areas that should be examined and challenged. Treasury is directed to establish a threshold below which reporting is not required and may provide an exception for amounts that are not determinable.