

Legislative Update – NonQualified Plan Reforms

Changes to the rules governing non-qualified plan deferral elections, distribution options, and investment choices were passed by the U.S. Senate on May 11th. These changes, contained within S. 1637, the JOBS bill, will be taken up by the full House where final passage is expected. The non-qualified reforms had earlier been approved by the House Ways and Means and Senate Finance Committees. The reforms will generally require that existing deferred compensation plans be reviewed and revised to eliminate common features such as “haircut” withdrawals, deferrals for periods of less than five years, and the deferral of stock option gains.

Major provisions of reform legislation include stricter rules on the timing of deferral elections, and distribution restrictions, including the elimination of in-service distributions (“haircut withdrawals”), a prohibition on elections to accelerate benefit payments, limits on changes in the time of, or form of, a scheduled payment, and tighter definitions of distributable events, such as disability and change of control. While the reforms will not address corporate owned life insurance, two specific funding practices would be prohibited, namely, the use of offshore trusts to hold executive plan assets, and the use of financial triggers to earmark assets to pay executive benefits. In addition, the legislation would require the annual reporting of deferred amounts on W-2 Forms.

The bill passed by the Senate contains several additional provisions, including a prohibition on deferral of gain from the exercise of a stock option or restricted stock, a restriction on available deferred compensation investment options (plans must maintain options “comparable to the company’s 401(k) plan), a prohibition on payments to top 5 executives within 1 year of change of control, a requirement that only 1 election to defer a scheduled payment be allowed by plan, and an additional 10% tax penalty on tax liabilities from non-compliance.

The provisions would apply to amounts deferred, and earnings on these amounts, after 12/31/2004, and could therefore require that plan sponsors administer two sets of rules for participant accounts, applicable to pre-2005 and post-2004 deferrals and earnings. Following the enactment of the reforms, the IRS would write regulations within 90 days defining many key provisions of the legislation.