

New Legislation Makes Significant Changes to Non-Qualified Deferred Compensation Plan Rules

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Congress has just passed the American Jobs Creation Act of 2004 (the "Act"), which includes provisions that significantly change the tax rules relating to non-qualified deferred compensation plans. The Act is expected to be signed by the President soon. The new rules imposed by the Act generally are effective with respect to amounts that are considered under the Act to have been deferred on or after January 1, 2005. For this purpose, amounts deferred before January 1, 2005 are considered to be deferred on or after January 1, 2005, and thus are subject to the new rules, if and to the extent that they vest on or after January 1, 2005, or if the plan is materially modified after October 3, 2004.

The Act provides that Treasury Regulations are to be issued that will permit some time within which existing plans may be retroactively amended to comply with the new rules, and for participants to revoke elections for 2005 as a result of the law changes. Nevertheless, the changes are significant, and most employers will wish to communicate the changes to participants before they make their deferral elections with respect to their 2005 compensation. Accordingly, all non-qualified deferred compensation plans should be reviewed as soon as possible to determine the changes that will be required to comply with the new rules.

Executive Summary

The most important provisions of the Act relating to non-qualified deferred compensation plans may be summarized as follows:

- Distributions from non-qualified deferred compensation plans only would be permitted on account of death, disability, separation from service, at a specified time or pursuant to a fixed schedule, on account of a change in control (to the extent permitted by regulations), or on account of an unforeseeable emergency.
- Provisions permitting an acceleration of the timing of benefit payments (such as those allowing for distributions subject to a 10% "haircut" penalty) will cause benefits to be immediately taxable.

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- Initial deferral elections generally will need to be made prior to the taxable year for which the compensation is earned.
- Subsequent elections as to the timing or form of payments generally would need to be made at least 12 months before the payments otherwise would commence, and subsequent deferrals generally would need to be for at least 5 years.
- Violations of these rules will result in immediate tax plus interest (at the tax underpayment rate plus 1%) from the date of the deferral and an additional tax of 20% of the taxable compensation.

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- Transfers of assets to offshore trusts and employer financial triggers will cause benefits to be immediately taxable.

What You Should Do Now

In light of the significance of the changes made by the Act, the breadth of types of plans that may be subject to the new requirements, and the January 1, 2005 effective date, we recommend that employers take the following immediate action:

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- Identify any plans or arrangements they maintain that fall within the broad definition of a non-qualified deferred compensation plan under the Act.
- Analyze the changes that would be required to be made to each plan in order to satisfy the new law.
- Avoid making any amendments to their plans that would result in a loss of grandfathering of amounts that are considered to have been deferred prior to January 1, 2005. In general, we recommend that employers delay if possible making any amendments to their nonqualified deferred compensation plans until Treasury Regulations are issued clarifying some of the provisions of the Act. If amendments need to be made, however, care must be taken to be sure that they do not add any benefit, right or feature to the plan that could cause a loss of grandfathering for deferrals made before January 1, 2005.
- Consider adopting new plans for deferrals after January 1, 2005 to ensure that grandfathering will not be lost for existing deferrals.
- Communicate the changes to plan participants as soon as possible, so that they are aware of them before they make their 2005 elections. Also, communicate to participants the extent to which their consent will be required to make any changes.

Definition of Non-Qualified Compensation Plan

The new tax rules apply with respect to "non-qualified deferred compensation plans", which are broadly defined to include any plans that provide

for the deferral of compensation. The term "plan" is defined to include an agreement or arrangement with one or more persons. "Qualified employer plans", and any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit are not treated as non-qualified deferred compensation plans for purposes of these rules. The term "qualified employer plan" is defined to include any plan that is qualified under §401(a) of the Internal Revenue Code of 1986, as amended (the "Code") (including pension, profit sharing and 401(k) plans), annuity plans or contracts described in §403(a) or §403(b), simplified employee pensions described in §408(k), any simple retirement account described in §408(p), any eligible deferred compensation plan described in §457(b) and any qualified governmental excess benefit arrangement described in §415(m) of the Code.

The Conference Report, prepared by the staff of the House and Senate Conference Committee, that summarizes and explains the provisions of the Act (the "Conference Report") indicates that it is not intended that the term "non-qualified deferred compensation plan" include "any arrangement taxable under §83 of the Code providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant, if such arrangement does not include a deferral feature other than the feature that the optionholder has the right to exercise the option in the future." The Conference Report also indicates that the provision is not intended to change the tax treatment of incentive stock options meeting the requirements of §422 or options granted under an employee stock purchase plan meeting the requirements of §423, or to change the rules applicable to annual bonuses paid within 2 1/2 months after the close of the taxable year in which the relevant services required for payment have been performed.

By negative implication from the language of the Conference Report, it would appear that the new rules may apply with respect to options to pur-

chase employer stock where the exercise price is less than the fair market value of the underlying stock on the date of grant (or options, perhaps whether or not discounted, to purchase assets other than employer stock), and to arrangements pursuant to which income derived from the exercise of a stock option is deferred to a date after the date on which the option is exercised. The new rules also would seem to apply with respect to restricted stock units and any arrangements to delay the recognition of income with respect to restricted stock that has vested, and most likely also will apply in some manner to be prescribed by Treasury Regulations with respect to stock appreciation rights and phantom stock arrangements.

New Requirements

The Act imposes three basic requirements that must be satisfied by all non-qualified deferred compensation plans.

Distribution Requirements

Under the first set of requirements, compensation deferred under the plan may not be distributed earlier than: (i) separation from service, as determined pursuant to Treasury Regulations to be issued; (ii) the date on which the participant becomes "disabled"; (iii) the date on which the participant dies; (iv) a time (or pursuant to a fixed schedule) specified under the plan when the deferral election is made, (v) to the extent provided within Treasury Regulations, a change in the ownership or effective control of the corporation, or in the ownership of the substantial portion of the assets of the corporation, or (vi) upon the occurrence of an "unforeseeable emergency".

The Act also provides that distributions cannot be made to "specified employees", of publicly traded companies on account of separation from service until six months after the date of separation from service (or, if earlier, the date of the employee's death). A "specified employee" is defined for this purpose as a "key employee" within the meaning of

§ 416(i) of the Code, which generally includes officers receiving compensation in excess of \$130,000 (as adjusted for inflation), 1% owners receiving compensation in excess of \$150,000, and 5% owners.

For purposes of these rules, the term "unforeseeable emergency" is defined to be a severe financial hardship to the participant resulting from an illness or accident of the participant, the participant's spouse or a dependent (as defined in §152(a) of the Code) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. Further, to qualify for distribution on account of an "unforeseeable emergency," the amounts distributed with respect to the emergency cannot exceed the amounts necessary to satisfy the emergency, plus amounts necessary to pay taxes reasonably anticipated as result of the distribution. The amount needed is determined after taking into account amounts that would be received by the participant by insurance or that could be obtained, without severe financial hardship, through the liquidation of the participant's assets.

A participant is considered to be disabled under the new rules if he or she (i) "is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer."

No Acceleration of Benefits

The second new requirement applicable to non-qualified deferred compensation plans is that the

“In general, compensation for services performed for a taxable year may be deferred at the participant’s election only if the election is made not later than the close of the preceding taxable year or at such other time as provided in Treasury Regulations.”

plan may not permit the acceleration of the time or schedule of any payment under the plan except as provided in Treasury Regulations. Many existing plans include provisions that permit participants to elect to receive distributions of their deferred benefits subject to a penalty (typically 10% of the amount withdrawn). Practitioners generally believe that such a penalty constitutes a "substantial risk of forfeiture", and that the participant therefore is not in constructive receipt of his benefits as a result of the existence of such a right under the plan. This feature has provided participants reasonable comfort in knowing that if financial conditions of the employer deteriorate, they at least can access 90% of their funds and thereby prevent them from being subject to creditor claims against their employer. The new law would preclude participants from making this election with respect to amounts deferred (or deemed under the effective date provisions of the new rules to be deferred) on or after January 1, 2005.

The Conference Report indicates that changes in the form of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions. The Conference Report goes on to state, however, that this rule is not violated merely because the plan provides a choice between cash and taxable property if the timing and amount of the income inclusion is the same regardless of the medium of distribution, and that Treasury Regulations should be issued under which the choice between different forms of actuarially equivalent life annuity payments is permitted. Treasury Regulations also are intended to provide other limited exceptions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective. The Conference Report provides, as examples of the types of exceptions that should be provided in the Regulations, distributions to comply with a court-approved settlement incident to a divorce,

amounts required to be withheld to pay the employee's share of employment taxes, or amounts required to be withheld as income taxes due upon a vesting event under § 457(f). The Conference Report also indicates that it is intended that Treasury Regulations would provide that automatic distributions of minimal interests for administrative convenience would not violate the prohibition on acceleration.

Election Requirements

The Act sets forth rules regarding the timing for making initial elections under the plan and elections changing the time or form of distributions under the plan.

Initial Elections

In general, compensation for services performed for a taxable year may be deferred at the participant's election only if the election is made not later than the close of the preceding taxable year or at such other time as provided in Treasury Regulations. Under this rule, for example, an election to defer an annual bonus earned in 2005 and normally payable in January of 2006 would need to be made by December 31, 2004 unless the exception for performance based compensation described below applies. In the initial year in which an individual becomes eligible to participate in the plan, the election can be made with respect to services to be performed subsequent to the election within 30 days after the participant becomes eligible to participate in the plan.

In the case of "performance-based compensation" based on services performed over a period of at least 12 months (i.e., a bonus based upon performance criteria measured over a performance period that extends over 1 year or more), the election may be made no later than 6 months before the end of the performance period. The Conference Report indicates that rules similar to those used under § 162(m) of the Code would be

used to determine whether compensation is "performance based" for this purpose. Thus, in order to constitute "performance based compensation", the Conference Report indicates that the amount would have to be variable and contingent on satisfaction of "pre-established" organization or individual performance criteria and not readily ascertainable at the time of the election. The performance criteria would need to be specified in writing within 90 days after the service period begins.

Changes in Time and Form of Distribution.

If a plan permits participants to elect to delay a payment or change the form of payment after its initial deferral, the election must meet the following requirements:

- The plan must require that the election takes effect at least 12 months after the date on which the election is made.
- The first payment to which the election applies must be deferred for a period of not less than 5 years from the date such payment would otherwise have been made (except in the case of an election related to a payment on account of the participant's disability, death, or an unforeseeable emergency).
- The plan must require that any election related to a payment at a specified time or pursuant to a fixed schedule may not be made less than 12 months before the date of the first scheduled payment.

Consequences of Failure to Meet New Requirements

The Act generally provides that if at any time during a taxable year a non-qualified deferred compensation plan fails to meet the new requirements of the Act, or is not operated in accordance with those requirements, then all compensation deferred under the plan for the taxable year and all preceding taxable years is or becomes taxable to the extent it is not subject to a sub-

stantial risk of forfeiture and was not previously taxable. The tax imposed as a result of these new rules would be increased by interest at a rate equal to the rate imposed on tax underpayments plus one percentage point, and an additional tax equal to 20% of the compensation required to be included in income.

The foregoing rules apply only to participants with respect to whom the failure relates, and thus not necessarily to all participants in the plan.

Funding Requirements

The Act also imposes new rules relating to the funding of non-qualified deferred compensation plans.

Offshore Trusts

Under the new rules, assets set aside in a trust to pay deferred compensation are treated as property transferred in connection with the performance of services (and thus would be taxable under § 83 of the Code if they are no longer subject to a substantial risk of forfeiture or are transferable) if and when they are located or transferred outside of the United States. This provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the non-qualified deferred compensation relates are performed in that jurisdiction.

Triggers Based Upon Employer's Financial Health

Similarly, participants will be deemed to have received property within the meaning of Section 83 as of the earlier of the date on which the plan first provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health, or the date on which assets are so restricted.

The Conference Report indicates that the transfer of property occurs under the foregoing rule as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. The Conference Report states that if, for example,

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a Plan provides that upon a change of the employer's financial health, a trust will become funded to the extent of all deferrals, then all amounts deferred under the Plan are treated as property transferred under § 83 at the time of deferral (even if the assets of the trust to which deferrals would be transferred would be available to satisfy the claims of the employer's general creditors). The Conference Report states further, however, that this provision is not intended to apply when assets are restricted for a reason other than a change in the employer's financial health (such as upon a change in control) or if assets are periodically restricted under a structured schedule and the scheduled restrictions happen to coincide with a change in financial status.

If assets are treated as transferred under the foregoing rules relating to offshore trusts and employer financial triggers, then any increase in value in, or earnings with respect to, those assets are to be treated as additional transfers of property as realized. Amounts required to be included in income under the foregoing provisions are increased by interest (at the tax underpayment rate plus 1%) and an additional tax equal to 20% of the taxable amount).

Aggregation Rules

Subject to any exceptions provided in Treasury Regulations, the aggregation rules related to controlled groups under §§ 414(b) and (c) are to be applied in connection with the Act's new rules, and Treasury Regulations are to be issued to carry out the purposes of this provision. Thus, for example, the Conference Report indicates that it is intended that those aggregation rules would provide that separation from service from one entity within a controlled group, but continued service for another entity within that group, would not be a permissible distribution event. Similarly, the aggregation rules would preclude distributions from being made to participants employed by one member of a controlled group as a result of a change in control of another member.

Authority to Issue Treasury Regulations

The Act authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the Act, including regulations:

- providing for the determination of the deferred amounts in the case of a non-qualified deferred compensation plan that is a defined benefit plan;
- relating to changes in the ownership and control of a corporation or assets of a corporation for purposes of determining when distributions on account of changes in control may be made;
- exempting certain arrangements from the new funding rules if those arrangements will not result in an improper deferral of tax and will not result in assets being effectively beyond the reach of creditors;
- defining "financial health" for purposes of the funding rules; and
- disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of the new rules. The Conference Report states that it is intended that substantial risks of forfeiture be disregarded if they are illusory, such as if an executive is effectively able to cause the time when the risk of forfeiture lapses to be accelerated.

The Conference Report also indicates that Treasury Regulations may be issued relating to stock appreciation rights and payments under non-elective, supplemental retirement plans.

Reporting Requirements

The new rules will require that deferred compensation be reported on a Form W-2 (or Form 1099), even if it is not currently taxable, subject to an exception that may be established by Treasury Regulations for certain de minimus amounts. The Conference Report indicates that it is expected

that these annual reporting requirements will provide the IRS with an indication of what arrangements should be examined or challenged.

Effective Date

The new rules generally apply with respect to amounts deferred on or after January 1, 2005, and to earnings on deferred compensation only to the extent that the deferred compensation itself is subject to the new rules. Treasury Regulations are to provide guidance as to when an amount is considered to have been deferred for this purpose. The Conference Report states that the timing of an election to defer should not be determinative of when the deferral is made.

The Conference Report further provides that for purposes of the effective date, an amount is considered to be deferred before January 1, 2005 if the amount is earned and vested before that date. It thus appears that amounts deferred before January 1, 2005, but that do not vest until on or after January 1, 2005, will be subject to the new rules.

For purposes of this effective date provision, amounts deferred in taxable years beginning before January 1, 2005 are to be treated as amounts deferred in a taxable year beginning on or after that date, and thus would be subject to the new rules, if the plan under which the deferral is made is "materially modified" after October 3, 2004, other than to conform the plan to the new requirements of the Act. The Conference Report states that the addition of any benefit, right or feature is a material modification, but that the exercise or reduction of an existing benefit, right or feature is not a material modification.

The Conference Report also states that existing plans that comply with current law and are not materially modified after October 3, 2004 may continue to be operated in accordance with their terms with respect to amounts deferred before January 1, 2005. Thus, for example, amounts deferred before January 1, 2005 under such a plan could be further deferred, and distributions could be accelerated, to the extent permissible under prior law.

The Act further provides that not later than 60 days after the date of its enactment, the Secretary of the Treasury must issue guidance providing a limited period during which a non-qualified deferred compensation plan adopted before December 31, 2004 may, without violating the requirements under the new Act, be amended (1) to provide that a participant may terminate participation in the plan, or cancel any outstanding deferral election with regard to amounts deferred after December 31, 2004, but only if amounts subject to termination or cancellation are includable in the income of a participant as earned (or if later, when no longer to substantial risk of forfeiture), and (2) to conform to the requirements of the new rules with regard to amounts deferred after December 31, 2004.

The Secretary of the Treasury also is required to issue guidance within 90 days after the enactment of the Act on what constitutes a change in ownership or control for purposes of the new rules.

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