Originally published in:
The Tax Executive *November 15, 2004*

A Revolution in the World of Deferred Compensation

By: Norman J. Misher and David E. Kahen

I. Introduction

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (the "Act"). The Act added a new section, Section 409A to the Internal Revenue Code (the "Code"), which will govern the taxation of nonqualified deferred compensation plans. The new provision contains specific requirements that will significantly limit how and when participants are able to defer compensation under nonqualified deferred compensation plans, and reduces the flexibility that participants currently have under many such plans to change the time and form of the payment of their benefits after the initial deferral. The new provision also places specific restrictions on the funding of nonqualified deferred compensation plans. Finally, the new provision imposes significant penalties for failing to satisfy the new requirements.

The new provision is an apparent reaction to certain deferred compensation strategies that Congress has perceived to be abusive, such as techniques to further defer or to accelerate distributions at the participant's discretion. Congress appears also to have been reacting to certain highly publicized situations (e.g., Enron) where executives in nonqualified plans avoided to some degree the adverse impact of business developments that had a severe adverse impact on participants in qualified plans. For example, the acceleration of distributions under nonqualified plans allowed executives participating in these plans to incur smaller economic losses than those borne by rank-and-file participants in qualified plans holding stock of the affected employer.

The new provision generally applies only to amounts deferred after December 31, 2004. Thus, it is imperative that employers immediately review their deferred compensation arrangements and make the necessary changes in order to ensure compliance with the new requirements.

This article is intended to guide tax executives through the significant changes made to the tax rules governing nonqualified deferred compensation plans and addresses:

- Definition of a "nonqualified deferred compensation plan"
- Requirements that must be met by such plans to avoid the current inclusion income

- -- Election requirements for deferrals and distributions
  - -- Restrictions on distributions
  - -- Prohibition on acceleration of distributions
- Interest and additional tax for failure to comply with the new rules
- Funding issues
  - -- Foreign trusts
  - -- Restriction on use of assets due to employer's financial condition
- New IRS reporting requirements
- Effective date rules

II. Definition of a Nonqualified Deferred Compensation Plan

Under Section 409A, a nonqualified deferred compensation plan is broadly defined as any plan that provides for the deferral of compensation, except for (1) qualified employer plans (such as Section 401(k) plans, pension plans and tax-deferred annuities) and (2) bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plans. Additionally, the Conference Committee Report for the Act (the "Conference Report") explains that for purposes of Section 409A, the following are not intended to be treated as nonqualified deferred compensation plans:

- nonqualified stock options with an exercise price not less than the fair market value of the underlying stock on the date of grant;
- incentive stock options meeting the requirements of Code Section 422 and employee stock purchase plans meeting the requirements of Code Section 423; and
- annual bonuses or other annual compensation paid within 2-1/2 months after the close of the taxable year in which the relevant services were performed.

Thus, in addition to salary and bonus deferrals arrangements, it appears that nonqualified deferred compensation plans under Section 409A will include supplemental executive retirement plans (SERPs); phantom stock plans; restricted stock units; stock appreciation rights;[1] discounted

[1] Section 409A may effectively rule out the issuance of SARs in their typical form, absent favorable guidance from the IRS. The Conference Report notes that issues relating to SARs may be addressed in regulations.

stock options; and Code Section 457(f) "ineligible" deferred compensation plans of tax-exempt organizations and state and municipal governmental units. The provision specifically states that a "plan" includes an agreement or arrangement that includes one person. Consequently, an executive's employment or severance arrangement that contains a compensation deferral feature will likely be subject to the new restrictions imposed by Section 409A. Finally, it is important to note that Section 409A is not limited to arrangements between an employer and employee and, thus, will apply to, for example, deferred compensation arrangements between a corporation (or other person) and one or more of its outside directors or independent contractors.

It is not at all clear whether the new provision is intended to apply to arrangements between partners in a partnership that might plausibly be characterized as deferred compensation, such as an agreement by one partner in a services partnership to accept a smaller allocation of profit in one year in exchange for a larger allocation in a later year. This is one of many issues under Section 409A with respect to which guidance from the IRS is needed. This issue is not addressed in the legislative history, and it is unclear whether guidance on this issue will be forthcoming quickly (or at all).

III. Requirements to Avoid Current Inclusion of Deferred Compensation

Under Section 409A, all amounts deferred after 2004 under a nonqualified deferred compensation plan will be currently includible in gross income (except to the extent such amounts are subject to a "substantial risk of forfeiture") unless the plan meets the election and distribution requirements described below.

A. Election Requirements for Deferrals and Distributions

1. Initial Deferral Election

Generally, a participant's initial deferral election with respect to compensation for services to be rendered during a calendar year must be made prior to the start of such calendar year. Since most existing plans have required salary deferral elections to be made prior to the year in which the salary is earned, this rule should not significantly affect current salary deferral procedures. However, many plans currently permit bonus deferral elections to be made during the calendar year in which all or a portion of the services to which the bonus relates are rendered. Under the new provision, unless the exception for performance-based compensation described below applies, plan procedures will have to be changed for future bonuses.

A special deferral election timing rule is provided for newly eligible participants. Under this rule, participants in their first year of eligibility have up to 30 days after they became eligible to participate in the nonqualified deferred compensation plan to make their deferral elections with respect to compensation for services to be rendered subsequent to the election.

2. Deferral Election for Performance-Based Compensation

Section 409A provides a special deferral election rule for compensation that is "performance-based." Under this rule, the initial election to defer performance-based compensation, based on services performed over a period of at least 12 months, must be made at least six months before the end of the service period.

Performance-based compensation is not defined in Section 409A. According to the Conference Report, it is intended that Treasury guidance will define performance-based compensation to include compensation that is (a) variable and contingent on the satisfaction of previously established organizational or individual performance criteria and (b) not readily ascertainable at the time of the deferral election.

The Conference Report further provides that performance-based compensation may be required to meet some (but not all) of the requirements applicable to the performance-based compensation exception provided in the $1 million deduction limitation rules of Code Section 162(m), which are applicable to compensation paid by a publicly held corporation to certain of its executives. For example, performance criteria would be considered preestablished if they are established in writing no later then 90 days after the start of the applicable service period, but the Section 162(m) requirement that the performance criteria be determined by the compensation committee of the board of directors of the corporation would not apply.

3. Elections as to Time and Form of Distributions

In general, Section 409A requires that the time and form of a distribution to be made from a nonqualified deferred compensation plan be specified at the time of the initial deferral. This can be accomplished either by having the plan specify the time and form of payments that are to be made due to a distribution event, or by permitting the participant to elect the time and form of payment at the time of the initial deferral election. According to the Conference Report, a plan could allow participants to elect different forms of payment for different permissible distribution events. For example, a participant could elect a lump sum distribution upon disability but an annuity upon attaining age 65.

The new provision does, however, permit nonqualified deferred compensation plans to allow participants to make changes in the time and form of distributions with respect to previously deferred compensation under certain circumstances. In general, the plan may allow participants to elect to delay payment or change the form of payment if the following conditions are satisfied: (a) the election change cannot be effective until at least 12 months after the date on which the new election is made; (b) the payment must be deferred for a period of at least five years from the date that the payment would otherwise have been made (but this requirement does not apply with respect to elections relating to distributions on account of death, disability or unforeseeable emergency); and (c) if the participant changes his election relating to a payment to be made at a specified time (or pursuant to a fixed schedule), the election must be made at least 12 months before the date of the first scheduled payment.

B. Restrictions on Distributions

Under Section 409A, distributions of amounts deferred under a nonqualified deferred compensation plan may occur only for the following reasons:

1. Separation from Service

A participant may receive a distribution from a nonqualified deferred compensation plan when the participant separates from service. However, "key employees"[2] who are employed by a corporation any stock of which is publicly traded may not receive a distribution earlier then six months from the date of their separation from service.

In determining whether a separation from service has occurred, aggregation rules are to apply similar to the controlled group rules under Code Sections 414(b) and 414(c) applicable to qualified plans. Thus, for example, participants would be eligible to receive a distribution from their nonqualified deferred compensation plan only if they separated from service from all of the entities in their former employer's controlled group.

2. Death or Disability

A distribution from a nonqualified deferred compensation plan may be made upon a participant's death or if the participant becomes disabled. A participant is considered disabled if: (1) the participant is unable to engage in any substantial gainful activity due to a medically determinable physical or mental impairment that is expected to result in death or last for a continuous period of at least 12 months, or (2) due to a medically determinable physical or mental impairment that is expected to result in death or last for a continuous period of at least 12 months, a participant receives income replacement benefits for at least 3 months from an employer-provided accident and health plan.

3. Specified Time

A participant may receive a distribution from a nonqualified deferred compensation plan at a specific time, or pursuant to a fixed schedule, that is specified under the nonqualified deferred compensation plan at the time of the deferral of compensation. The Conference Report explains that payments upon the occurrence of an event will not qualify as a payment at a specific time. For example, an amount that is payable to a participant from a nonqualified deferred compensation plan when the participant's child begins college would not be considered to be paid at a specific time and, thus, would not be permissible. By contrast, amounts payable from a plan when a participant attains age 65 would be considered as being payable at a specified time.

4. Change in Control

A participant may receive a distribution from a nonqualified deferred compensation plan, to the extent provided by Treasury guidance, in the event of a change in the corporation's ownership or effective control, or in the ownership of a substantial portion of the corporation's assets. The statute specifically requires that the guidance as to what constitutes a change in

---

[2] "Key employees" generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer of greater than $150,000.

ownership or effective control be issued within 90 days after the date of enactment, i.e., by January 20, 2005. The Conference Report states that it is intended that the Treasury use a definition of change in control that is similar to, but more restrictive than, the definition of change in control for purposes of the golden parachute provisions of Code Section 280G.

The Conference Report also indicates that the aggregation rules discussed above with respect to distributions upon a separation from service will not apply to distributions in connection with a change of control, so that if there is a change of control of one member of a controlled group, participants who are employees of another member of the controlled group would generally not be eligible to receive a distribution from a nonqualified deferred compensation plan maintained by the other members.

5. Unforeseeable Emergency

A distribution from a nonqualified deferred compensation plan may be made on account of a participant's incurrence of an unforeseeable emergency. Generally, an unforeseeable emergency is defined as a severe financial hardship to the participant resulting from "extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant," including a hardship resulting from an illness or accident of the participant or the participant's spouse or dependent,[3] or the loss of the participant's property due to casualty.

A distribution on account of an unforeseeable financial emergency may not exceed the amount needed to satisfy the emergency plus the taxes anticipated on such distribution. Further, such distributions are not permitted to the extent that the financial hardship may be relieved by insurance or otherwise by the liquidation of the participant's other assets (other than a liquidation that would itself cause severe financial hardship).

C. Prohibition on Acceleration of Distributions

Under Section 409A, a nonqualified deferred compensation plan may not permit the acceleration of a distribution under the Plan, except to the extent permitted by Treasury regulations. In general, a change in the form of a distribution that accelerates payment would be subject to the acceleration prohibition. For example, it appears that, absent favorable guidance from Treasury, a participant will not be permitted under the provision to change the form of a distribution from installments to a lump sum, or change to a shorter term of installments for a distribution.

Many nonqualified deferred compensation plans currently permit a participant to receive an in-service withdrawal at any time so long as the withdrawal results in a financial penalty, such as the forfeiture by the participant of a portion, e.g. 10 percent, of the amount withdrawn

[3] Section 409A refers to the definition of a dependent contained in Code section 152(a). Under Section 152(a), a participant's dependent includes not only the participant's "qualifying child" but also a "qualifying relative," such as a parent, sibling, or domestic partner, if certain requirements are met. The Working Families Tax Relief Act of 2004 (P.L. 108-311) recently amended Section 152(a) in a manner that tightened the requirements to qualify as a dependent. Those changes to Section 152(a) may effectively preclude certain distributions that could otherwise have been authorized under the "unforeseeable emergency" exception.

(commonly referred to as a "haircut"). Such haircuts and other in-service distributions (other than unforeseeable emergency distributions and distributions payable at a specific time) are now prohibited by Section 409A and, thus, will not be available for amounts deferred after 2004. Further, it appears that a provision calling for accelerated distributions by reason of a plan termination may not be permissible.

As mentioned above, Treasury regulations may provide for limited exceptions to the prohibition on accelerated distributions. As explained in the Conference Report, it is intended that the acceleration prohibition will not be violated because of the availability of different types of payment options, provided that the timing and the amount of the income inclusion is the same regardless of the option elected. For example, it may be permissible to offer a choice between distributing an amount as a fully taxable annuity contract or as a lump sum. A choice between different, but actuarially equivalent, life annuity payments may also be permissible.

The Conference Report further provides that it is intended that, when an accelerated distribution from a nonqualified deferred compensation plan is not elective and is required for reasons beyond the control of the participant, Treasury guidance may provide that the prohibition on acceleration of distributions will not be violated. Some examples provided in the Conference Report of the types of distributions that may be permitted include: distributions pursuant to a court-approved divorce settlement; distributions for the payment of an employee's share of employment taxes; and automatic cash-out distributions of minimal amounts (e.g., accounts of less than $10,000) upon permissible distribution events, such as separation from service (subject to the six-month rule noted above for key employees of publicly traded companies).

Overall, the new rules clearly reduce flexibility by precluding certain types of initial and subsequent deferral elections from being made in the time and manner now provided for in many plans. On the favorable side, however, there is a greater degree of certainty with respect to the tax treatment of those subsequent elections that are specifically authorized under the new provision.

IV. Effects of Failure to Comply with Election and Distribution Requirements

If a nonqualified deferred compensation plan fails to comply with any of the requirements described in the preceding section, all compensation deferred with respect to a participant to whom the failure relates is subject to immediate inclusion in the income of the participant, except to the extent these amounts are subject to a "substantial risk of forfeiture" (in which case the income is postponed until that risk lapses) or have previously been included in the participant's income. Participants must pay interest, computed at the IRS underpayment rate plus 1 percentage point, and must also pay an additional tax equal to 20 percent of the amount required to be included in gross income.

A. Participants affected by failure to satisfy the requirements

Those participants in a nonqualified deferred compensation plan with respect to whom there is a failure to satisfy the election and distribution requirements will be taxed currently on their deferred amounts under the plan. For example, if a nonqualified deferred compensation plan permits all participants to receive distributions earlier than permitted under the applicable requirements, then all of the participants are required to include in their income the amounts deferred under the plan before those amounts are paid. If, however, only certain executives are eligible to receive an early distribution of their deferrals that is not permitted under the new rules, only those executives would be required to include in their gross income currently all of the amounts that were deferred for them under the plan.

B. Amounts included in gross income

A participant with respect to whom there is a failure to satisfy the election and distribution requirements must currently include in gross income all amounts deferred for the participant under the plan, plus any interest or earnings on those amounts, except to the extent the amounts are subject to a "substantial risk of forfeiture" or have previously been included in the participant's income. Section 409A essentially incorporates the definition of "substantial risk of forfeiture" contained in Code Section 83(a), relating to transfers of property in connection with the performance of services. Under these rules, the rights of an individual to compensation are subject to a substantial risk of forfeiture if such individual's rights to the compensation are conditioned on the future performance of substantial services. The Conference Report provides that the Treasury may issue regulations under which a substantial risk of forfeiture will be disregarded if it is used to manipulate the timing of income inclusion, if the risk of forfeiture is illusory, or if the risk of forfeiture conflicts with the purpose of Section 409A. For example, a substantial risk of forfeiture may be disregarded "if an executive is effectively able to control the acceleration of the lapse" of the substantial risk of forfeiture.

C. Interest and Additional Tax on Amounts Included in Gross Income

Participants with respect to whom a nonqualified deferred compensation plan fails to satisfy the requirements of Section 409A must pay interest and an additional tax on the amount required to be included in gross income, in addition to paying tax currently on the compensation deferred under the plan.

The interest, which is treated as interest on an underpayment of tax, is determined by reference to the underpayments of tax that would have occurred if the deferred compensation had been included in gross income for the taxable year in which first deferred or, if later, for the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture. The interest rate is equal to the underpayment rate under Code Section 6621(a) plus one percentage point.

In addition to the current income inclusion and the interest charge, a substantial additional tax is imposed on amounts deferred under plans not meeting the election and distribution requirements. The additional tax is equal to 20 percent of the amount that must be included in gross income.

V. Changes Relating to Funding

Section 409A imposes two restrictions with respect to the "funding" of nonqualified deferred compensation plans. First, the use of offshore trusts to hold assets for the payment of amounts under nonqualified deferred compensation plans will generally result in the acceleration of income for participants. Second, a set-aside of assets for a nonqualified deferred compensation plan that is triggered by a change in the financial health of the employer will have similar adverse tax consequences.

A. Foreign Trusts

Section 409A imposes adverse tax consequences on the use of trusts located outside of the United States to fund nonqualified deferred compensation plans. However, the provision includes an exception for the use of foreign trusts where substantially all of the services relating to the deferred compensation are performed in the foreign jurisdiction where the assets are located.

Any assets held in a foreign trust under circumstances not within the narrow exception described above are treated as property transferred in connection with the performance of services under Section 83, and, in general, must be included in the gross income of participants at the time that: (1) the assets are set aside, if the assets were originally located outside of the United States, or (2) the assets are transferred to a foreign trust, if the assets were originally located in the United States trust and were subsequently transferred to the foreign trust. Any subsequent increases in the value of, and earnings with respect to, these assets are treated as additional transfers of property, and are therefore also required to be included in income.

B. Restriction on Use of Assets due to Employer's Financial Condition

Section 409(A) also provides that employer assets will be treated as property transferred to participants in connection with the performance of services under Section 83 to the extent the employer assets are restricted to the payment of benefits under a nonqualified deferred compensation plan in connection with a change in the employer's financial condition. Such treatment will result from a restriction of assets (or commitment to restrict assets) in connection with a change in financial condition even if the assets remain available to satisfy the claims of general creditors (such as in the case of a transfer to a rabbi trust).

In general, the amount of the restricted assets must be included in the participants' gross income on the earlier of: (1) the date that a plan first provides that assets are restricted to providing benefits due to a change in the employer's financial condition, or (2) the date that the assets are so restricted, whether or not such assets are available to satisfy claims of general creditors. The Conference Report states that it is intended that a transfer of property to participants be deemed to occur to the extent of the assets so restricted. For example, if a plan provides that the use of assets equal to the aggregate amount of plan deferrals will be restricted to the payment of participants' deferred compensation in connection with a change in the employer's financial condition, then an amount equal to all of the participants' deferred compensation under the plan will be treated as property transferred in connection with the performance of services under Section 83 and, in general, currently included in gross income. Any subsequent increases in the value of, and earnings with respect to, the restricted assets are treated as additional transfers of property, and are therefore also required to be included in income.

The rule regarding asset restrictions upon a change in an employer's financial condition does not apply when employer assets are required to be restricted by reason of certain other events that coincide with a change in the employer's financial condition. The Conference Report explains that examples of permitted restrictions in the use of assets include a restriction imposed upon a change in control, or if assets are periodically restricted under a structured schedule that coincides with a change in the employer's financial condition.

C. Interest and Additional Tax

Participants who are required to include the value of trust assets or the amounts of their deferred compensation in their gross income under these rules must also pay interest and an additional 20 percent tax. These amounts are computed in the same manner as with respect to violations of the election and distribution requirements as described above.

VI. Reporting and Withholding Requirements

The Act also includes reporting and withholding provisions for amounts deferred under a nonqualified deferred compensation plan. An individual's Form W-2 (or Form 1099) must show the amount of the individual's deferrals under a nonqualified deferred compensation plan regardless of whether such amounts must be included currently in the individual's gross income. Also, amounts includible in an individual's income under Section 409A are required to be reported on the individual's Form W-2 (or Form 1099) for the year of inclusion. Further, amounts includible in the income of an employee under Section 409A are treated as wages subject to withholding in the year in which the deferrals are includible in income.

VII. Effective Dates

Generally, the new provision applies only to compensation amounts that are deferred after December 31, 2004. The Conference Report states that an amount is considered to be deferred if the amount is earned and vested prior to that date. The report also states that earnings on compensation that is deferred prior to January 1, 2005, will not be subject to Section 409A if the deferred amounts to which the earnings relate are not subject to the new provision.

A nonqualified deferred compensation arrangement that is valid under current law and that is not materially modified after October 3, 2004, is not subject to the new provision with respect to amounts deferred before 2005. Thus, according to the Conference Report, subsequent deferrals after 2004 under such a plan with respect to amounts initially deferred before 2005 will remain subject to present law but will not be subject to the new provision. The Conference Report further indicates that the IRS may challenge the effectiveness of such subsequent deferral elections for tax purposes if such elections are not compliant with the tax law prior to the Act.

A. Material Modifications to Pre-Effective Date Nonqualified Deferred Compensation Plans

A deferral under a nonqualified deferred compensation plan that occurs prior to January 1, 2005, is subject to Section 409A if the plan is materially modified after October 3, 2004, unless the modification is pursuant to guidance issued by Treasury regarding termination of certain existing plans or elections, or regarding amendments to conform to the new provision.

As explained in the Conference Report, the addition of any benefit, right, or feature is considered a material modification. For example, a material modification would occur if an employer added a "haircut" distribution provision to a plan after October 3, 2004, or if the schedule for vesting of benefits under the plan were accelerated by an amendment after that date. However, an action such as changing the plan administrator or removing a distribution provision is not considered to be a material modification. Because all pre-2005 plan deferrals are potentially subject to the new rules if such a material modification occurs, most employers are using extreme caution in modifying plans pending the issuance of initial guidance by the IRS under the new provision.

B. Transition Relief

Section 409A provides that, within 60 days after the date of enactment (that is, by December 21, 2004), guidance will be issued by Treasury which will provide for a limited period during which a nonqualified deferred compensation plan adopted before December 31, 2004, may be amended (1) to provide that a participant may cease participation in the plan or cancel a deferral election for amounts deferred after December 31, 2004 (with such amounts being includible in the participant's gross income as earned or, if later, when no longer subject to a substantial risk of forfeiture); or (2) to conform to the new provision.

*** * * * ***

Taking into account the extensive changes made by Section 409A, it is generally anticipated that most deferred compensation plans will be terminated, or amended or replaced with new plans (at least for post-2004 deferrals), after guidance is released by the IRS concerning interpretation and implementation of this new provision. In light of the onerous penalties that apply in the event of failure to comply with the new provision, as well as the widely reported increased scrutiny by the IRS of executive compensation generally, many employers will undoubtedly be rethinking whether certain deferred compensation arrangements should be continued in any form. If nonqualified deferred compensation plans are to be continued, employers must carefully evaluate the steps necessary to ensure compliance with the new provision.