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American Jobs Creation Act of 2004 Changes the Rules for Nonqualified Deferred Compensation Plans

As you may know, the American Jobs Creation Act of 2004, which President Bush is expected to sign into law shortly, will radically change the tax rules applicable to nonqualified deferred compensation arrangements. For the first time, the Internal Revenue Code will include specific rules regarding permissible timing of deferred compensation elections, events triggering payouts and funding methods. Failure to comply with the new rules in form or operation can result in deferred compensation being taxed from the outset (or when it vests, if later), rather than at the deferred payment date. In addition, special penalty taxes and interest assessments will apply to deferred compensation not paid in accordance with the new rules

In combination, the new rules will make deferred compensation arrangements far less flexible. The AJCA will impact virtually every deferred compensation arrangement affecting U.S. taxpayers, apparently including private executive pensions (SERPs) and many equity compensation arrangements like phantom stock and stock appreciation rights. Even some plans maintained by charities and other tax-exempt organizations will be affected.

Congress gave the IRS broad discretion on how to apply the new law and the IRS is required to issue some of its guidelines within 60 days after enactment. Compensation that was deferred and vested before 2005 is grandfathered out of the law. However, the new rules may apply to deferred compensation which vests after 2004, even if it was credited before 2005 pursuant to a written and binding contract. When the IRS does issue its guidance, employers and employees will be given a chance to amend nonconforming arrangements in order to preserve the anticipated tax treatment.

Given an impending January 1, 2005 effective date, all employers are encouraged to now start reviewing their various deferred compensation arrangements. Decisions may need to be made and changes implemented in short order. To assist our clients and friends in this process, this memo summarizes the primary provisions of the deferred compensation portions of the AJCA.

A. COVERAGE

New Internal Revenue Code Section 409A sets out the new rules, which generally apply to all arrangements that defer compensation for common law employees, non-employee directors and independent contractors. Covered arrangements include both group plans and individual agreements (like an employment contract), and the new rules apply to both non-elective and elective deferred compensation. Specific exceptions are provided for tax-qualified benefit plans (such as 401(k) plans); tax-sheltered annuities; some, but not all, plans maintained by governmental agencies and tax-exempt organizations; and health and welfare plans. Compensation paid within 2-1/2 months after the close of the year in which earned is not subject to the new rules.

The House-Senate Conference Committee Report on the AJCA indicates that the new law is not intended to apply to Section 423 employee stock purchase plans (ESPPs). Stock options granted at a fair market value exercise price will apparently not be subject to the new rules if the options do not contain a deferral feature (other than the right to exercise the option); however, stock options issued at a discount exercise price may well be subject to the new law. The Conference Report suggests that the IRS should issue rules regarding the applicability of the new law to stock appreciation rights. Contrary to widespread reports, however, it is not yet clear whether the new law applies to stock appreciation rights having a fair market value strike price; if it does, the most commonly used form of stock appreciation rights is unlikely to comply with the new rules (i.e., SARs that are freely exercisable after vesting). Also, it is not yet clear whether or how the new law will apply to other equity-based arrangements with deferred tax characteristics, like phantom stock and restricted stock units. For private equity sponsors, some "realization event" plans may be at risk.

B. DEFERRAL ELECTIONS

1. Initial Deferral Elections

The new law generally provides that a deferral election must be made before the end of the tax year preceding the year in which the services attributable to the compensation are performed. In the case of "performance-based compensation" based on services performed over a period of at least twelve months, the election must be made no later than six months before the end of the applicable service period; compensation is "performance-based" for this purpose if it complies with rules similar to those described under Section 162(m) of the Code, although Congress left it up to the IRS to determine in future guidance an exact definition of that term. Newly-eligible participants will have 30 days after first becoming eligible for a deferred compensation arrangement to make a deferral election, but only with respect to compensation attributable to services performed after the election.

2. Re-Deferral Elections

For plans that permit later elections to change the timing or form of payment, the plan must provide that any such later election will not be given effect until at least twelve months after it is made. If the election in question relates to payments not triggered by death, disability or unforeseeable emergency, the new payment date must be at least five years after the date the payment otherwise would have been made. Finally, elections changing a specified payment date must be made at least twelve months before the first scheduled payment under the original election.

C. TIMING OF DISTRIBUTIONS

1. Permissible Distribution Events

Under the new law, compensation deferred under a nonqualified deferred compensation plan may not be distributed earlier than one of the following:

- Separation from service or, for "key employees" (as defined in the Code's "top-heavy" rules) of public companies, six months following separation from service;
- Death;
- The date the participant becomes "disabled" (as defined in the new law);
- A specific time (or times) determined when the compensation is first deferred (but, according to the Conference Report, not upon the occurrence of a specified event);
- A change in the ownership or effective control of the employer or in the ownership of a substantial portion of the assets of the employer, to the extent provided in future IRS guidance; or
- An "unforeseeable emergency" (as defined in the new law), with the distribution being limited to the amount needed to satisfy the emergency plus the taxes incurred on the amount distributed.

According to the Conference Report, payments may be made "only upon" one of these dates, while the text of the law itself merely requires that payment not be "earlier than" one of these dates. Consequently, it is not clear whether termination of employment will create a new flexibility for subsequent distributions.

2. Acceleration of Payment

Distributions may only be accelerated in limited circumstances specifically sanctioned by future IRS guidance. Examples cited by the Conference Report include accelerated distributions to comply with a court-approved divorce settlement or to allow the employer to withhold amounts to satisfy employment taxes. The new law also provides that plans may not pay out deferred compensation on demand even if a financial penalty ("haircut") is imposed on the amount deferred.

D. FUNDING

1. Financial Health Triggers

If a plan provides that assets will be set aside for benefits upon a change in the employer's financial health, then the compensation deferred under the plan will be taxable at vesting. A similar rule applies if assets in fact become restricted to the payment of benefits following a change in an employer's financial health. In both cases, early taxation can occur even if the assets remain subject to the claims of the employer's general creditors. These provisions are intended to prevent the use of so-called "springing rabbi trusts" and "springing secular trusts" which become effective or are first funded upon a change in the employer's financial health.

2. Offshore Trusts

The use of an offshore trust to fund deferred compensation will generally trigger tax when the deferred compensation vests, except to the extent the IRS states otherwise in future guidance. These rules will generally not apply to foreign trusts providing compensation for offshore services.

E. PENALTIES FOR VIOLATING THE NEW RULES

A failure to follow the new rules with respect to a specific participant will cause all amounts deferred and vested (and any earnings thereon) to be immediately taxable to that participant. In addition, the participant will owe (i) an additional twenty percent (20%) tax on the amount included in his or her income, plus (ii) interest on the underpayments which would have occurred had the compensation been taxable when deferred (or vested, if later), at a rate equal to the IRS underpayment rate plus one percent (1%).

F. INCOME TAX REPORTING AND WITHHOLDING

An employer is required to report amounts deferred by, or on behalf of, a participant under a nonqualified deferred compensation plan on the participant's Form W-2 (or Form 1099-MISC if the participant is not an employee) for the tax year in which the deferral occurs. Reports may not be required for certain *de minimis* amounts, to be established by the IRS in regulations. The employer also must withhold taxes on any amounts includable in income because of the new law.

G. EFFECTIVE DATE

The new law is generally applicable to amounts deferred in 2005 and subsequent years. According to the Conference Report, an amount is considered "deferred" before January 1, 2005 if the services required to earn the amount have been performed and the amount has vested. Significantly, this means that the new law may apply to deferred compensation credited but not vested before by January 1, 2005, such as unvested accruals under a SERP. Tax law changes frequently do not apply to binding contracts in place before the key effective date, so it is conceivable that IRS might grandfather at least some unvested pre-2005 deferrals pursuant to binding contracts in place before 2005; however, given the Conference Report language such grandfathering appears unlikely.

Amounts deferred and vested before 2005 are grandfathered out of the new law, but can become subject to the new rules if the arrangement under which they are deferred is materially modified after October 3, 2004. A material modification does not include amending the arrangement in accordance with forthcoming IRS guidance in order to comply with the new law with respect to post-2004 deferrals. However, the Conference Report indicates that the addition of any benefit, right or feature will be a material modification, for example, an amendment to accelerate vesting or add a "haircut" payment acceleration provision.

Subsequent deferral elections for amounts deferred before 2005 will not subject such amounts to the new rules, provided the applicable arrangement is not materially modified after October 3, 2004.

H. TRANSITIONAL RELIEF AND OTHER IRS FORTHCOMING GUIDANCE

The IRS is required to issue some of the required guidance no later than 60 days following the new law's enactment. This may have been intended to allow a brief 2004 post-guidance amendment period to conform existing arrangements to the requirements of the new law and/or permit participants to stop participating in a plan or cancel a deferral election for post-2004 compensation. However, it is now unclear if the new law will be signed by the President before the November election, which means that the IRS might not be required to issue guidance until after the law's January 1, 2005 effective date. Treasury officials have informally announced that the IRS guidance, whenever issued, will provide employers with flexibility to both change existing arrangements and terminate pending deferral elections.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Employee Benefits and Executive Compensation Group, including the Co-Heads of the Group, Robert C. Fleder (212) 373-3107 and Michael J. Segal (212) 373-3364.

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