

NONQUALIFIED DEFERRED COMPENSATION PROVISIONS IN THE AMERICAN JOBS CREATION ACT OF 2004

October 13, 2004

Now that both the House and the Senate have passed the tax bill containing changes to the rules for nonqualified deferred compensation and the White House has indicated that the President will sign it (probably before the election), the emphasis now shifts to the Treasury Department and the Internal Revenue Service to provide additional guidance regarding the interpretation of these rules. Initial IRS guidance is expected to be forthcoming within the 60-day post-enactment period set forth in the statute.

In a recent speech, Bill Sweetnam (Benefits Tax Counsel at the Treasury Department) and other individuals discussed the new rules and the guidance that would be forthcoming. It was promised that the guidance would be issued timely, i.e. within the 60-day post-enactment period specified in the statute, and that it would provide substantial relief for existing nonqualified deferred compensation arrangements. In fact, it was flatly stated that plans in place currently for which elections normally would be made between now and the end of the year should continue to operate in accordance with their existing practices and participants should go ahead with their 2004 elections. Transition relief apparently will allow plan participants the ability to either conform to the new statutory rules (apparently the IRS is planning to waive the new timing rule for elections in 2004, at least with respect to bonuses for 2004 that are payable in 2005) or to take their money in 2005 and pay tax on it if they do not wish to comply with these rules. In short, according to the statements that were made by these government officials, employers should continue to operate their existing deferred compensation plans in the same manner that they have been and expect that the transition relief that will be out before the end of the year will provide alternatives to rectify what otherwise would be expected universal non-compliance with the new rules.

The government speakers recognized that year-end deferral elections for 2004 bonuses and other amounts that will not be vested before year-end, cannot comply with the new rules. (As noted above, timing of the elections would not comply with the new rules). Because of this, the IRS and the Treasury Department are indicating that they will provide transition relief that will allow the arrangements to be fixed retroactively within a grace period (probably three to six months long) to be set forth in the IRS guidance.

Pursuant to that grace period, the participant will be permitted (by the end of the grace period) to change his or her election and take the deferred amount in 2005 without any adverse tax consequences (other than the taxation of the income as received); that is, the deferral can be “unwound.” Also as part of this guidance, the government will provide a “snap-on”

RA Bench

amendment that will allow the plan to be in temporary compliance with the new rules (with full documentary compliance required by the end of 2005). In this way, the deferred amounts from the 2004 election can either be distributed to the participant in 2005 (without penalty) or the plan can come into compliance with the new rules and the deferral election (as adjusted to comply with the new rules) can continue as intended.

It may be worth repeating, as was brought out in the speech, that any attempt to secure grandfather treatment by vesting deferrals before year-end will be considered a “material modification” that automatically loses grandfather treatment. Amounts that are not vested this year will be subject to the new rules of section 409A.

In addition to these comments, other issues were raised in this program, including the potential application of these new deferred compensation plans to other types of plans. For example, severance plans may be subject to these rules as well as restricted stock unit plans in which the amounts are not payable in the same year as they vest. SARs, SERPs and phantom stock plans will also be under these rules. It was also noted that deferred compensation plan provisions that permit the termination of the plan and the immediate payout of all benefits will no longer be acceptable unless the termination of the plan is tied to an acceptable distribution event such as change of control. Therefore, companies that wish to terminate deferred compensation plans would not be able to do so without adverse tax consequences until all amounts are paid out in accordance with participant elections.

Legal analysis by Buchanan Ingersoll PC