New Restrictions on Executive Deferred Compensation Plans

Insights
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The American Jobs Creation Act of 2004 significantly revises certain long-standing employee benefits tax laws and will affect virtually every non-qualified deferred compensation plan maintained by private and tax-exempt employers. The new law establishes a number of design requirements that plans must meet or participants will be subject to taxes and penalties on the amounts deferred, plus interest. Employers should immediately conduct a review of their non-qualified deferred compensation arrangements to determine what action needs to be taken.

Deferred compensation is popular with executives because it reduces current income taxes by postponing the taxation and receipt of income (and usually earnings on that income) until a later time. The new tax law includes rules that apply to the timing of elections to defer income and to changes with respect to the time and form of payment. The law applies to deferrals made on and after January 1, 2005, provided that the deferred compensation plan is not materially modified after October 3, 2004. Regulations are expected in December 2004. Even though restrictive, this legislation provides certainty in an area that has had limited formal IRS guidance.

PLANS TO WHICH THE NEW REQUIREMENTS APPLY

The new requirements apply to plans with voluntary deferrals of salary or bonuses, supplemental and excess benefit plans (SERPs), employment arrangements with deferred payment requirements, phantom stock plans, and may apply to equity based compensation such as restricted stock, stock appreciation rights (SARs) and discounted stock options.

THE CHANGES TO DEFERRED COMPENSATION PLANS

Initial Elections

- Deferral elections must be made in the year prior to the taxable year in which the service is performed (although new plan participants have 30 days to make an election to defer future compensation).
- Deferral elections that apply to performance-based bonuses for services performed over a period of at least 12 months must be made at least 6 months before the end of the relevant service period.

Distribution Events

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- Plan distributions cannot be made earlier than separation from service, disability, death, a set date or fixed schedule, change in control (as permitted by the IRS), and unforeseeable emergency.

Changes to the Time and Form of Payment

- If the Plan allows for a change in the time and form of payment, an extension of the time for distribution, as well as changes in the form of a distribution, must be made at least twelve months prior to the original commencement date and cannot be effective for twelve months. Further, the election must extend the initial commencement date a minimum of five years.
- Payments cannot be accelerated.

Other Changes In The Law

- Haircut provisions (a right to an immediate distribution in exchange for a reduction in the amount owed) are not allowed.
- Income tax withholding requirements and W-2 reporting of deferred compensation apply.
- The rate of withholding on supplemental wage payments over one million dollars is increased.

TAX CONSEQUENCES OF NON-COMPLIANCE

Failure to comply with the new requirements will subject plan participants to additional tax by requiring all the deferred compensation to be included in income and be subject to interest and a penalty charge of 20% of the amount includable in income.

EMPLOYER ACTION STEPS

Employers who sponsor Plans subject to the new law should immediately assess how the law impacts their plans. Plans must be analyzed to determine whether amendments need to be made to election and distribution arrangements, or to determine if the plans should be frozen or terminated. If plan amendments require approval by the Board of Directors, meetings need to be scheduled before year end.

For more information or for help in this analysis, contact any member of Fisher Phillips' Employee Benefits Practice Group or your regular FP lawyer.

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