AALU's Washington Report

Premier analysis of federal legislative and regulatory developments for the nation's 2000 most advanced life insurance planners, focusing on business, estate, qualified and nonqualified retirement planning.

Counsel

Buchanan Ingersoll PC
Gerald H. Sherman
Stuart M. Lewis
Deborah M. Beers
Norma Sharara

PricewaterhouseCoopers
William Archer
Donald Carlson

Federal Policy Group
Ken Kies
Patrick J. Raffaniello
Timothy Hanford
Jim Carlisle

Ricchetti Inc.
Steve Ricchetti
Jeff Ricchetti

AALU

Executive Vice President
David J. Stertzer

Director of Government Affairs
Tom Korb

Assoc. Dir. of Gov. Affairs
Marc R. Cadin

2901 Telestar Court
Falls Church, VA 22042
Phone: (703) 641-9400
Fax: (703) 641-9885
www.aalu.org

AALU Bulletin No: 04-133 October 8, 2004

Subject: **Analysis of Deferred Compensation Provisions in the American Jobs Creation Act of 2004**

Major References: ***Section 885, American Jobs Creation Act of 2004***

Prior AALU Washington Reports: *04-128, 04-127; 04-126; 04-118; 04-94*

MDRT Information Retrieval Index Nos.: *2400.00; 7400.023*

One of the most significant aspects of the tax bill currently being finalized by Congress is the dramatic rewrite of the tax rules applicable to nonqualified deferred compensation arrangements. These rules can be expected to affect every deferred compensation plan in the United States, whether elective or nonelective, whether established through formal plan structures or simple board resolutions, and whether applied to a group of employees or to a single executive. Because of the short timeframe in which employers must react and adapt to these new rules, it is imperative that prompt and careful consideration be given to these new deferred compensation rules and to their consequences. (See our Bulletins Nos. 04-128, 04-127, 04-126, 04-118, and 04-94.)

DESCRIPTION

The legislation, which has now passed the House of Representatives and is awaiting Senate action, would create a new section in the Internal Revenue Code, section 409A, which would establish a series of rules applicable to nonqualified deferred compensation arrangements. These rules are divided into two groups. The first set of rules is applicable in determining whether and when constructive receipt has occurred with respect to the deferred compensation and the second set of rules establishes certain specific limitations for deferred compensation plans. Notably, one of the more difficult aspects of the rules that were under consideration by the Conference Committee (the specific investment requirement under which nonqualified deferred compensation plans would have had to replicate the investments in the employer's

401(k) plan) fortunately, and in major part due to AALU efforts, was eliminated by the Conference Committee. Nevertheless, these new rules will limit to some degree the flexibility currently available to most deferred compensation arrangements.

1. Constructive Receipt Rules

New section 409A imposes three new sets of constructive receipt rules in addition to all existing rules. That is, all of the existing rules regarding constructive receipt, economic benefit and assignment of income continue to apply, as well as these new requirements.

(a) Distribution. The new distribution rules provide that compensation deferred under a plan may not be distributed any earlier than the occurrence of one of six specified events. Those events are:

(i) separation from service;

(ii) the date the participant becomes disabled;

(iii) death;

(iv) a specified time (or fixed schedule) specified under the plan at the date of the deferral;

(v) a change in ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation; and

(vi) the occurrence of an unforeseeable emergency.

In addition, key employees (as determined under the top-heavy rules of section 416)[1] of a publicly traded corporation may not receive a distribution by reason of separation from service for at least six months after that separation.

For purposes of the statute, a participant is disabled if he (1) is unable to engage in any substantial gainful activity by reason of any medically determined physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or (2) is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can 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 three months under an accident and health policy covering employees of the employer.

With respect to the fourth specified event, i.e., that the amount be paid at a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral, the Conference Report states that a specified time is, in fact, a date and not a specified event. For example, if the distribution is made on the event of an executive's child entering college, that would not constitute a specified time but payment at age 65 would.

With respect to the fifth specified event, i.e., a change in ownership or control, that requirement is subject to rules to be established by the Internal Revenue Service. Thus, the IRS will presumably, in the

[1] Officers with compensation over $130,000, 5% owners and 1% owners with compensation over $150,000.

relatively near future, provide guidance as to the types of changes in ownership or control that will be a permissible distribution event under this rule. The conference report directs that the definition be similar to, but more restrictive than, the golden parachute definition in section 280G.

Finally, the term "unforeseeable emergency" is defined as a severe financial hardship to the participant resulting from illness or accident of the participant, the participant's spouse or a dependent or loss of the participant's property due to casualty or other similar extraordinary unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution on unforeseeable emergency may not exceed the amounts necessary to satisfy the emergency and pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such hardship is or may be relieved through reimbursement or compensation by insurance or by liquidation of the participant's assets.

(b) Acceleration. By contrast, the acceleration provision in the new statute is relatively brief. It simply states that the plan cannot permit the acceleration of the time or schedule of any payment under the plan except as permitted by the IRS in regulations. This is clearly directed at preventing any type of acceleration, including the use of a heretofore popular technique called "haircuts." Under the haircut approach, a substantial penalty (for example, 10% of the amount involved) was imposed on any acceleration of a distribution under the theory that the penalty was sufficient to prevent constructive receipt. This statutory provision would eliminate that technique.

The conference report provides additional details. It indicates that a choice between a lump-sum and an annuity payout may be permitted (as well as a choice between cash and taxable property). It also specifies certain exceptions that would be implemented through IRS guidance:

- accelerated distributions beyond the participant's control (e.g., distributions to comply with federal conflict of interest or court orders pursuant to divorce);
- withholding of employment taxes;
- distributions necessary to pay income taxes due to vesting in a section 457(f) plan; and
- distributions of minimal amounts for "administrative convenience," e.g., cash-out of amounts of $10,000 or less (except for key employees, as discussed above).

(c) Elections. The third aspect of the new constructive receipt requirements establishes rules under which elections must be made. These rules closely parallel those that have long been used by the IRS as constructive receipt safe harbors. However, in practice, many (if not most) employers have utilized much more flexible election rules and as a consequence, these new rules will substantially change the election procedures that employers must follow in order to avoid adverse tax consequences for their executives.

Two election rules are provided -- one for initial elections and one for changes in the time and form of distribution. Under the first, amounts deferred at the participant's election will only avoid adverse tax consequences if the election to defer is made not later than the close of the preceding taxable year (or at such other time as provided in regulations). Like the existing IRS rules, a second special rule is provided for the first year in which a participant becomes eligible to participate in a plan. In that case, the election may be

made with respect to services to be performed subsequent to the election so long as the election is made within 30 days after the date the participant becomes eligible to participate in the plan.

Of particular importance is a special rule for "performance-based compensation." In the case of any such compensation based on services performed over a period of at least 12 months, the deferral election may be made no later than six months before the end of the period. The statute does not, however, define performance-based compensation. The Conference Report states that it has a meaning similar to the term used under section 162(m) but does not have to meet all of those requirements. For example, in order to constitute "performance-based compensation," the amount would have to be variable and contingent on satisfaction of "preestablished" organizational or individual performance criteria and not readily ascertainable at the time of the election.

The preestablished goals requirement mandates that the performance criteria be specified ***in writing*** within 90 days after the service period begins. However, unlike the mandate of section 162(m), the compensation committee of the board of directors would not have to certify that the goals were met. Performance-based compensation is likely to include such things as bonuses but only if the employer satisfies these new special conditions.

The other set of election rules in the statute deals with changes in time and form of distribution. If a plan permits a subsequent election to delay a payment or change the form of a payment, these rules require that (1) the election may not take effect until at least 12 months after the date on which the election is made, (2) if the election relates to a distribution to be made on separation from service, a specified time or a change of control, then the payment with respect to which the election is made must be deferred for a period of at least five years from the date the payment would have otherwise been made and (3) if the election relates to a specified time, then it must be made at least 12 months before the date of the first scheduled payment.

Contrary to the rest of these new statutory rules, the set of rules with respect to subsequent elections in effect arguably represent a liberalization. Under existing law, serious questions exist about the ability to make subsequent elections. The now superceded court cases provided an uncertain and somewhat conflicting set of principles with respect to the ability to make subsequent elections.

2. Penalties

A violation of the normal nonstatutory constructive receipt rules results in the deferred compensation being taxable to the executive at the time of deferral. Statutory interest (at IRS rates) would be imposed on any tax deficiency and the IRS might, in some cases, seek to assess a penalty for negligence.

Under the new statutory constructive receipt rules, a specific tax penalty regime is automatically established. If a plan fails to meet all of the requirements described above or is not operated in accordance with those requirements, all the compensation for the taxable year and all preceding years is includable in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture (and not previously included in income). In addition to being includable in income, these amounts are subject to additional taxable additions. First, the amount is increased by the amount of interest determined under the statute, which is the IRS underpayment rate plus one percentage point from the time the amounts would have been includable in gross income for the year first deferred (or if later, the first taxable year in which the amount is not subject to a substantial risk of forfeiture). Second, a flat tax increase of 20% of the

compensation amount is added. Thus, if the IRS underpayment rate is 5% and an individual three years earlier failed to include in income $10,000 of deferred compensation that did not satisfy the new statutory requirements of section 409A, the individual would have to include in income $10,000 (assume the tax on this amount is $5,000) plus an interest amount (which would total 18% of $5,000 or $900) plus the 20% add-on of $2,000. In short, the executive would owe an income tax of $7,900 for violating the rules of section 409A.

The Conference Committee did provide an important clarification and point of relief with respect to these penalty inclusion amounts. The statute now specifies that if a deferred compensation plan fails to meet these requirements with respect to a single individual, only that individual is subject to the penalties set forth in the statute. In other words, the noncompliance does not necessarily adversely affect every plan participant. However, if the plan operationally fails to satisfy these requirements, issues might arise whether the operational failure affects more than one participant and therefore, the tax status of other participants could be jeopardized as well, depending on the nature of the violation.

3. Funding Rules

The new statute contains two specific funding rules. The first rule is designed to prevent the use of off-shore rabbi trusts and the second rule is designed to prevent certain types of trigger plans that are intended to protect the executive in the event of the employer's financial difficulty.

Under the first rule, if assets are set aside directly or indirectly in a trust (or other arrangement determined by the IRS) for the purpose of paying deferred compensation, the assets are treated as property transferred in connection with the performance of services whether or not the assets are available to satisfy the claims of creditors. Under this rule, if a US employer were to establish a nonqualified deferred compensation plan for its executives and fund that plan with a rabbi trust that was located in Bermuda, the Cayman Islands or some other foreign jurisdiction, the amounts placed in the trust would be treated as a funded arrangement under section 83 and therefore, would be immediately taxable to the participant unless subject to a substantial risk of forfeiture.

An exception is provided if substantially all the services, to which the nonqualified deferred compensation relates, are performed outside of the jurisdiction. Nevertheless, significant issues arise concerning this arrangement in the case of nonqualified deferred compensation arrangements provided by non-U.S. companies. If a non-U.S. company or a foreign subsidiary of a U.S. company were to provide nonqualified deferred compensation arrangements, issues arise as to whether adverse taxation would result (unless that arrangement is "funded" with a U.S. rabbi trust). This could be a problem even where no rabbi trust is used since the statute applies whether the assets are set aside directly or indirectly. Determination of the reach of this statute in the case of non-U.S. employers will have to await further guidance from the IRS.

The other funding rule provides that, in the case of compensation deferred under a nonqualified deferred compensation plan, a property transfer under section 83 will occur as of the earlier of the date on which the plan provides that the assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health or on the date on which the assets are so restricted. This applies to "springing plans" which state that, on a decline in the employer's net worth (for example, to a specified figure), benefits are to be provided to the executives or to another trust (including a rabbi trust).

Violation of either of these funding requirements also results in the imposition of interest and the 20% penalty, as previously described.

4. Coverage

One of the most important aspects of the new legislation is the determination of the types of plans to which section 409A will apply. As defined in the statute, it applies to plans other than qualified plans and bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans. For purposes of this definition, the term "qualified plan" includes typical profit sharing and pension plans qualified under section 401(a), tax-deferred annuities, eligible deferred compensation plans under section 457(b) (but not ineligible plans under section 457(f)), SEPs and SIMPLES. In addition, the term "plan," as used in the statute with respect to nonqualified deferred compensation is specified to include an agreement or arrangement that covers one person. A special exception is also provided for nonelective deferred compensation arrangements for nonemployees under section 457(e)(12) of the Code under certain limited conditions.

The coverage provisions of the statute are particularly notable in that they do not contain an exception is intended to provide a means by which the IRS can reach below market stock options and other similar section 83 arrangements that it believes constitute a form of deferred compensation. The IRS will likely promptly issue guidance indicating that stock options granted at fair market value will not be covered by section 409A but that options with a discount (at least options with a significant discount) will, in fact, be fully subject to the new rules of section 409A (not merely the discount amount). Bonuses paid within 2 ½ months after the end of the year will be exempted, as well as incentive stock options under section 422 and employee stock purchase plans under section 423.

This new approach to treating forms of equity-type compensation as deferred compensation will have far-reaching consequences. For example, stock appreciation rights and phantom stock will be subject to these new rules even if paid in the form of stock. Further, a deferred compensation plan that converts to other forms of benefit is likely to be treated as violating the funding rules and also subject to these new requirements. Plans like stock appreciation rights plans are probably effectively dead because conforming those arrangements to these new rules will eliminate their usefulness; they in effect will become deferred compensation plans.

5. Withholding

The new statutory rules explicitly establish withholding requirements on the employer for any amounts includable in gross income as a result of new section 409A. Also, the deferred compensation amounts will be required to be reported on Form W-2 and Form 1099 when deferred, even though it is not yet taxable. (These new rules apply to both employees and independent contractors). Certain minimal amounts may not need to be reported.

6. Effective Date

Of tremendous immediate significance is the effective date of these new rules. In general, they apply to amounts "deferred" after December 31, 2004. (Earnings on amounts that are grandfathered are also grandfathered and not treated as additional deferrals). However, consistent with Congress' intent to prevent "stuffing" if a plan is "materially modified" after October 3, 2004 (unless the modification is acceptable under IRS guidance), then the grandfather treatment is lost and the amounts are subject to the new rules of section 409A. The IRS is directed to issue, within 90 days, guidance as to what constitutes a change in ownership and within 60 days, to provide guidance providing a limited period during which plans may be amended to conform to the requirements or to permit participants to terminate or change elections to comply with the statute. (This carries out the direction predicted in our Bulletin No. 04-118). The Conference Report states that the addition (but not the reduction) of any benefit, right or feature is a material modification.

The October 3 anti-stuffing provision presents a clear and immediate danger for employers and their executives. Until clear guidance is available, employers should be very cautious about amending or modifying any existing deferred compensation arrangements out of concern that they might lose grandfathered status for those arrangements.

A further question that arises under the effective date is what it means for amounts to be "deferred." On initial reading, it would appear to be based on the concept of when the amounts otherwise would have been paid as direct compensation to the individual. In other words, if amounts were deferred sometime during 2004 (or earlier) they would be subject to grandfather treatment under the statute. However, the Conference Report states that for this purpose, amounts are "deferred" only if they are both earned and vested. Thus, amounts deferred in earlier years that are still subject to a requirement of further service by the executive will not be considered deferred until the vesting occurs. If vesting is not scheduled to occur until 2005, these amounts will be subject to the new rules under section 409A. Further, any attempt to vest individuals before year-end would likely be deemed a material modification, thereby also triggering the application of the new rules.

An example may help illustrate this point. An executive defers from his compensation $50,000 in 2002 and $100,000 in 2003. These amounts are payable in 2010. However, in order to be entitled to the amounts deferred in 2002, the executive must be employed on December 31, 2004 and in order to receive the amounts deferred in 2003, the executive must be employed on December 31, 2005. Under the interpretation the IRS will apparently apply to the effective date rules for section 409A, the $50,000 deferred in 2002 will be grandfathered and neither the $50,000 nor any earnings on the $50,000 will be subject to these new rules as long as no material modification is made to that plan. However, the amounts deferred for 2003 do not vest until 2005 and therefore will be subject to the new rules.

NEXT STEPS

The legislation has already passed the House of Representatives and is expected to pass the Senate shortly. Even though Secretary of the Treasury Snow has indicated some dissatisfaction with the bill, there has been no indication that the President is likely to veto the legislation. In all probability, the President will sign the legislation most likely sometime after the election on November 2 (assuming, of course, that the Senate passes it, as expected).

The legislation specifically directs the IRS to issue certain guidance as described above. In carrying out that mandate, it is AALU counsel's understanding that the IRS and the Treasury Department are planning to issue, within 30-60 days after enactment, guidance that will deal with the issues required by the statute as well as clarifying the application of the effective date (as described above). In addition, it is expected that this guidance will provide a grace period under which plans can be modified to bring them into compliance with these new requirements. That grace period is likely to extend for three to six months. Rules will also be provided under which employees can cancel elections and exit plans if they do not wish to comply with the new rules. All of this will be based on the assumption that the existing plan complied with the constructive receipt rules as they existed before the enactment of section 409A.

The IRS also contemplates the issuance of a "snap-on" amendment that will enable employers to quickly adjust plans to comply with the new rules until there is more time available to do a more careful revision of plan documents. That assumes, of course, that employers wish to bring their plans into immediate and full compliance with these new requirements.

ACTION STEPS

In light of the massive and somewhat uncertain aspects of these new rules as they apply to deferred compensation plans, employers may want to consider a series of action steps in the immediate future. These steps, which of course should be subjected to review by employers' counsel and possibly employees' counsel, would include the following:

1. Determine What Plans are Subject to the New Rules. Because the coverage of section 409A is extremely broad, employers will have to determine what plans they have that are subject to the new rules. This will include not only any elective deferred compensation plan the employer has but also any SERP arrangements (even though those may be nonelective), any individualized deferred compensation (even if it only provides for deferred compensation in the executive's employment contract), bonus deferral plans, stock option plans that have an exercise price that was below the fair market value at the time it was granted, stock appreciation rights, phantom stock and anything that defers the receipt of compensation. For tax-exempt employers, this would include almost any deferred compensation arrangement that the employer might have other than a qualified plan and an eligible section 457(b) plan.

2. Determine How to Proceed. The employer will next need to decide how it wishes to proceed. A fundamental issue will be whether to freeze all existing plans that are grandfathered and create new plans for all future deferrals. Separating the grandfathered plan from any new deferral plans may be advisable because of concerns about making material modifications in the old plan and because it will likely be necessary to separate the funds in the old plan from the new plan for accounting purposes anyway because of the differences in the rules applicable to those amounts. While this is not a necessary requirement, it is one that may be appealing to employers. Employers should consider taking prompt action to begin drafting new plans (or modifying existing plans) in compliance with the new rules, as well as freezing existing plans.

3. Communication to Employees. The adverse tax consequences imposed by the statute impact the employee (or independent contractor) who has utilized the deferred compensation arrangement. Typically these programs are bilateral arrangements so that the employer does not have the right to make changes at least with respect to amounts already deferred. Employers may want to communicate to their executives

promptly the gravity and nature of the changes that will be confronted because executives will need to understand that the rules are changing significantly and will have to make decisions whether they wish to continue deferred compensation arrangements or not.

4. Obtaining Consent. With respect to any existing arrangements that need to be modified either to bring them into compliance with section 409A or otherwise, it probably will be necessary to obtain the consent of the executives to any action that needs to be taken. Once the executive understands the potential penalties applicable, the executive may be quite willing to agree to modifications but nevertheless the employer will need to contact each and every employee for whom consent is necessary.

Many practitioners are concerned about the amount of work that appears to be necessary and the short period of time (even with the IRS grace period) in which to get it accomplished. Larger employers have numerous deferred compensation plans, many of which are tucked away in employment agreements and other arrangements for executives. Just identifying all these arrangements may be a difficult task. The appropriate taxpayer course of action may involve different decisions for different types of arrangements. A careful understanding of these new rules is an essential predicate to any such action.

Any AALU member who wishes to obtain a copy of the new deferred compensation statutory language (section 885 of the American Jobs Creation Act of 2004) may do so through the following means: (1) Click on the hyperlink above next to "Major References" (2) log onto the AALU website at www.aalu.org, enter the *Members Portal* with your social security number and select *Current Washington Report* for linkage to source material (we are no longer using the Fax-on-Demand system); or (3) write to AALU, Attn: Leigh Foley, 2901 Telestar Court, Falls Church, Virginia 22042-1205, and include a reference to this Washington Report No. 04-133.