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NewsFlash!

MAJOR CHANGES IN THE TAX TREATMENT OF NONQUALIFIED DEFERRED COMPENSATION PLANS, AGREEMENTS AND ARRANGEMENTS

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On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004. It adds a new Section 409A to the Internal Revenue Code. Code Section 409A makes fundamental changes to the taxation of amounts deferred under “nonqualified deferred compensation plans.” Under Section 409A, severe penalties will be incurred by participants in a nonqualified deferred compensation plan if the plan fails to meet or is not operated in accordance with Section 409A and the regulations to be issued by the Internal Revenue Service.

Section 409A applies to amounts deferred after December 31, 2004 and earnings thereon, and to amounts deferred and related earnings if the deferral arrangement is materially modified after October 3, 2004.

The IRS is required to issue guidance within 60 days after October 22, 2004, providing a limited period of time during which nonqualified deferred compensation plans adopted before December 31, 2004 may be amended to (1) permit participants to terminate participation or cancel an outstanding deferral election with regard to amounts deferred after December 31, 2004, provided those amounts are includable in the participant’s income as earned (or, if later, when no longer subject to a substantial risk of forfeiture), and (2) conform to the requirements of Section 409A for amounts deferred after December 31, 2004.

What is Covered Under the New Rules

The new rules cover any “nonqualified deferred compensation plan” which is defined as any plan that provides for the deferral of any compensation other than (A) a qualified employer plan, and (B) any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. Thus, any nonqualified arrangement with any number of employees or non-employees, such as directors or independent contractors, providing for the deferral of compensation is covered. Examples include: voluntary deferral plans, supplemental and excess benefit plans and rabbi trusts.

Timing of Distributions

Distributions from a nonqualified deferred compensation plan may not be made earlier than: separation from service, disability, death, a time (or pursuant to a fixed schedule) specified under the plan at the date of deferral, a change in ownership or effective control over the employer or in the ownership of a substantial portion of the employer’s assets, or the occurrence of an unforeseen emergency. Distributions to “key employees” may not be made during the first six months following separation from service or, if earlier, the date of death of the employee.

With specified exceptions, a participant’s election to defer compensation must be made prior to the beginning of the taxable year in which the services giving rise

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to the compensation are performed, or at such other time as the regulations provide. Section 409A provides rules for subsequent elections.

Activities Causing Immediate Taxability

With limited exceptions, acceleration of payments before the time or schedule specified at the time of the deferral is prohibited.

Funding through off-shore trusts and restricting assets to the provision of benefits will be treated as transfers of property under Code Section 83, resulting in immediate taxation to the participant when the funds are no longer subject to a substantial risk of forfeiture.

If the distribution or deferral election requirements or limitations on acceleration of benefits of Section 409A are violated, all compensation (including earnings) deferred under the plan for the taxable year and all preceding taxable years becomes immediately taxable to the participants to whom the violation relates, unless those amounts are subject to a substantial risk of forfeiture or were previously included in income.

Interest at the underpayment rate plus 1% is imposed on the underpayments that would have occurred had

the deferred compensation been includable in gross income for the taxable year when first deferred, or, if later, when not subject to a substantial risk of forfeiture. In addition, a tax of 20% is imposed on the amount of compensation required to be included in the participant's gross income. Only those participants affected by a failure to comply with the new requirements will suffer the foregoing adverse consequences. Absent a material modification, only post-2004 deferrals will be impacted by Code Section 409A.

Employer Reporting Requirements

Code Section 409A requires employers to report annual deferrals under a nonqualified deferred compensation plan in box 12 of each employee's form W-2, using Code Y.

Employers should immediately review all of their deferred compensation plans, arrangements and agreements with their tax advisors to identify those that are subject to the new rules and to ensure compliance. All affected employees should be informed of the new rules. Particular attention should be paid to the "Definitions" section of 409A and to the regulations when issued.

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