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Tax Treatment of Deferred Compensation

Martin T. Goldblum
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Significant Changes to the Tax Treatment of Deferred Compensation

The American Jobs Creation Act of 2004 added Section 409A to the Internal Revenue Code which places new requirements on various types of nonqualified deferred compensation* to avoid constructive receipt. It creates a penalty tax of 20% on the affected participants if the requirements are not met either by the terms of the plan or arrangement or in operation. It applies to plans covering more than one employee or independent contractor and to individual contracts, to both elective and non-elective deferred compensation arrangements, phantom stock plans, stock appreciation rights, discounted options (subject to Treasury Regulations), restricted stock units, and the like. Section 409A applies to the deferral of income earned or amounts that vest after December 31, 2004.

Existing plans and grants should be reexamined under the new provision but should not be amended until the Treasury provides guidance on the manner and type of amendment. Amending the plans prematurely may lose the benefit of grandfathering for past deferrals.

Section 409A Distribution Requirements. In order to retain the benefits of deferred compensation, distributions may not be made earlier than the following events unless permitted by Treasury regulations:

- Separation from service (other than disability or death). For public companies, the payment must be delayed for six months after separation from service for the top 50 officers having annual compensation greater than $130,000, 1% owners having annual compensation of greater than $150,000, and 5% owners.
- Death.
- Disability, which is limited to an impairment expected to result in death or last for at least 12 months and results either in the participant's being unable to engage in substantial gainful activity or in the participant's receiving benefits for at least three months under an accident and health plan of the employer.
- A change of control (to be elaborated in Treasury regulations).
- A specified date or series of dates under the plan or deferral election.
- Unforeseeable emergency, which is limited to severe financial hardship due to illness, accident, casualty loss of property, or other unforeseeable circumstance beyond the control of the participant. Distributions may be made only if insurance and liquidation of the participant's assets would be inadequate (or a liquidation of assets would cause financial hardship). The amount subject to distribution is limited to the amount needed for the emergency grossed up for the expected taxes on the distribution. ***Comment***: This appears very difficult to administer and a mistake might be regarded as a violation in operation, with the result that all past and current deferrals might be included in the affected participant's gross income subject to regular tax, penalty tax and understatement interest at a 1% higher rate.

Voluntary Deferral Elections – Current Compensation. An election to defer salary or bonus must be made before the end of the taxable year preceding the taxable year in which the services are performed with respect to which the compensation is earned. There are two exceptions to this rule: (1) for the first year in which a person is eligible to participate, he or she may make an election within 30 days after eligibility to defer compensation in that year earned after the date of the election; and (2) performance-based compensation, to be defined in Treasury regulations, for services to be performed over a period of at least 12 months may be made at any time up to six months before the end of the service period.

Elections to Change Payment Date or Form of a Distribution. New elections to change the date or form of a distribution previously elected will not be effective for at least 12 months after they are made. If the new election relates to payments otherwise scheduled to be made on a specified date, it must be made at least 12 months prior to the first payment date. An election which further defers deferred payments to be paid upon separation from service (other than for death or disability) or a change in control or a specified date must cause the new deferral to be at least five years from the previously scheduled event or date.

Offshore Trusts and Setting Aside Assets in the Event of the Employer's Financial Difficulty are Prohibited. Whether or not the requirements for a "Rabbi trust" are met (that is, the assets set aside in trust may still be reached by the employer's general creditors), the funding of any foreign trust to satisfy deferred compensation (other than in respect of services performed offshore) or setting aside assets when the employer incurs financial difficulty will result in income and penalty taxes on the participant at such time as the benefit vests.

Equity-Based Compensation. Section 409A would not affect non-statutory stock options that are issued with an exercise price equal to fair market value at the date of grant. Stock appreciation rights as they are known today will not meet the requirements of the new legislation. The same may hold true for certain restricted stock units and possibly discounted options. These will have to be remodeled to conform to the law. Existing grants of these equity-based instruments will be subject to the new law if and to the extent they vest after December 31, 2004.

Penalties. Amounts that are deferred under nonconforming arrangements, either by their terms or in operation, will be taxed when earned or vested, as the case may be, and the participant will be subject to a penalty tax of 20% and the tax that would have been due had amounts been included in income at the time earned or vested will be subject to interest at 1% in excess of the underpayment rate. These are subject to withholding by the employer corporation along with the regular payroll taxes.

Reporting. Deferred compensation will have to be reported on Form W-2 for employees and Form 1099 for others in the year of deferral.

Treasury Guidance. The Treasury will provide guidance as to the amendments necessary to bring existing plans into conformity with the new provision.

*The new provision does not apply to the payment of income as earned, incentive stock options (Section 422), employee stock purchase plans (Section 423), sick leave and disability plans, qualified retirement plans under Section 401(a) (such as pension and profit sharing plans), and restricted stock.