

New Rules Govern Deferred Compensation Plans

The recently passed *American Jobs Creation Act of 2004* (Jobs Act) made several major fundamental changes to the tax treatment of nonqualified deferred compensation (NQDC) plans. Prompted by corporate scandals at Enron and other companies, the NQDC plans are subject to new restrictions and limitations, reining in what made the plans popular: flexibility.

Under the Jobs Act, NQDC plans must meet new distribution, election and funding requirements. Unless a plan meets all requirements, all cumulative compensation earned and deferred is includible in taxable income if it is not subject to a “substantial risk of forfeiture.” A 20% penalty and interest also will be imposed.

NQDC Plan Defined

An NQDC plan includes any plan that provides for compensation deferral, such as a traditional elective top-hat plan, deferred compensation arrangement under an employment or severance agreement, a Supplemental Executive Retirement Plan (SERP), phantom stock or stock appreciation rights. An NQDC plan generally *does not* include a qualified employer plan, *i.e.*, 401(k) plan or a vacation, sick leave, compensatory time, disability pay or death benefit plan.

The new rules also generally do not apply to performance-based annual bonuses or other annual compensation amounts paid within two and one-half months after the close of the tax year in which the relevant services were performed.

The term “plan” refers to any agreement or arrangement, including one that covers only a single person and is not limited to arrangements between an employer and employee. Thus, a “plan” also includes one that provides benefits to an outside director.

Effective Date

The new rules generally apply to amounts deferred after December 31, 2004, and to existing plans materially modified after October 3, 2004.

Recommendations

Congress has authorized the Treasury Department and the IRS to provide more guidance on the new rules. This guidance has not yet been issued but is expected to address key issues such as additional definitions, exceptions and transitional procedures.

In the meantime, employers should immediately:

- Identify all NQDC plans
- Cease to materially modify existing plans or make payments other than in accordance with existing elections until the additional guidance is issued
- Freeze (but do not terminate) existing plans
- Understand any compensation deferred after December 31, 2004, should be under a new plan that meets the requirements of the new rules

Before you take any action, contact us or qualified legal counsel to review the plan and explain the intricate new rules in more detail. To determine if the new rules apply to an arrangement, contact us as soon as possible to help.