

## IRS Publishes Initial Nonqualified Deferred Compensation Plan Guidance

On December 20, 2004, the IRS issued Notice 2005-1, providing initial guidance on [the new rules that apply to nonqualified deferred compensation plans as a result of the American Jobs Creation Act of 2004](#). In general, the new rules are effective January 1, 2005. However, due to the short timeframe between enactment of the law and this effective date, the IRS has provided a number of helpful transition rules for 2005:

- While plans must be operated in accordance with this guidance and a good faith, reasonable interpretation of the new rules as of January 1, 2005, plan sponsors have until December 31, 2005 to actually amend their plan documents to reflect the new rules.
- If a plan was in existence on or before December 31, 2004, participants will have until March 15, 2005 to make elections to defer compensation for services performed in 2005. Certain conditions apply and the election must be made before the amounts are paid or become payable. This means that, for 2005, participants will be able to make or change deferral elections after the beginning of the year.
- An employee who expects to receive a bonus in 2005, for services performed in 2004, has until the earlier of the actual bonus payment date or March 15, 2005, to make a deferral election on that bonus under a plan that was in existence on or before December 31, 2004.
- A plan sponsor may amend its plan before December 31, 2005, to permit new payment elections for contributions made in 2005 and nonvested contributions made before January 1, 2005. However, participants must make any new elections with respect to these contributions before December 31, 2005.
- A plan sponsor may amend its plan before December 31, 2005, to provide that during 2005 participants may terminate participation in the plan or cancel their deferral elections (in whole or in part). All amounts that would have been deferred under the cancelled elections must be included in participants' income in the tax year in which the amounts are earned and vested. In addition, a participant can request payment of amounts already deferred in 2005, and distribution of those amounts by December 31, 2005 will not violate the new law.
- A plan sponsor may amend its plan on or before December 31, 2005, to stop future deferrals and make payments to participants in 2005 (i.e., terminate the plan), without triggering penalties under the new law.

- During 2005, supplemental executive retirement plans (SERPs) may continue to permit payment elections to be governed by elections made under related qualified plans, even if those elections are made no more than 90 days before the payment starting date.

### **Grandfathered Benefits**

Any compensation deferred before January 1, 2005, but not vested by December 31, 2004, is subject to the new rules.

Amounts deferred before January 1, 2005, under plans that were in existence on October 3, 2004, remain subject to the old rules (i.e., are “grandfathered”), as long as no “material modifications” are made to the plan after October 3, 2004. The identification of the grandfathered amount depends on the type of plan involved:

- For defined contribution-type plans, the grandfathered amount is the vested account balance as of December 31, 2004, plus earnings on that amount.
- For defined benefit-type plans (e.g., excess benefit plans, SERPs), the grandfathered amount is the accrued and vested benefit as of December 31, 2004, including only those subsidies (such as early retirement subsidies) that the employee would be entitled to receive if he had terminated service as of December 31, 2004. Increases in the present value of this benefit due to the passage of time are also grandfathered.

Generally, a material modification occurs when a benefit or right that was in existence as of October 3, 2004, is enhanced (e.g., vesting is accelerated) or a new benefit or right is added (e.g., unforeseeable emergency provisions).

### **Permitted Plan Design Changes**

In the past, a plan sponsor could not amend a nonqualified plan to accelerate its vesting schedule. The new IRS guidance permits this type of change, as long as the new vesting schedule does not, itself, trigger payments. However, if this type of change is made with respect to pre-2005 deferrals or benefits, those benefits would no longer be grandfathered but would be subject to the new law.

Plan sponsors may also amend plans to allow an accelerated timing or schedule of payments:

- To comply with a domestic relations order;
- To comply with a certificate of divestiture under a conflict of interest situation;
- To pay income taxes due upon a vesting event under certain section 457 plans;
- To distribute certain de minimis amounts (\$10,000 or less) that meet certain conditions; or
- To pay employment (FICA) taxes.

In addition, plans may permit payments to be made upon a “change in control” of the sponsoring employer or the corporation liable for the payment. Change in control includes:

- A 50% change in the ownership of a corporation;
- A change in effective control of a corporation; or
- A 40% change in the ownership of a corporation’s total assets.

## **Reporting Rules**

Beginning with deferrals made in 2005, employers will have to report all nonqualified deferred compensation deferrals made during a calendar year on employees' Forms W-2, using code Y, even if those amounts are not taxable. The amounts reported will have to include both the amount of deferrals made in that year and the income attributable to those deferrals. This requirement applies to both defined contribution-type plans and defined benefit-type plans. However, amounts that are not "reasonably ascertainable" under defined benefit-type plans do not have to be reported until they are reasonably ascertainable.

In addition, payments made from nonqualified deferred compensation plans will be reported in box 12 of Form W-2, using code Z. All amounts distributed in a tax year must be reported, regardless of when they were contributed to the plan.

## **Additional Guidance to Follow**

The IRS has indicated that it will publish additional guidance regarding the new law requirements during 2005. We will keep you informed as this additional guidance become available. If you have questions about the application of these rules to your plan, please contact your Prudential Retirement representative.

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