



Update on the Issues

New Legislation

October 2004

Nonqualified Deferred Compensation Proposals Become Law

WHO'S AFFECTED This new law affects nonqualified deferred compensation plans. It does not apply to qualified plans (such as 401(k) plans), 403(b) plans and programs, section 457(b) plans, Simplified Employee Plans (SEPs), or SIMPLE plans.

BACKGROUND AND SUMMARY On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004. This new law includes the long awaited and much anticipated sweeping changes in the tax laws applicable to nonqualified deferred compensation plans. Generally, these new rules will require changes to most non qualified deferred compensation ("NQDC") plans and arrangements. The new law creates a new Internal Revenue Code section 409A, which will apply to amounts "deferred" after 2004. This new section of the tax law covers a variety of issues that previously were not specifically addressed, including rules for deferral elections, distributions and funding arrangements.

ACTION AND NEXT STEPS While the new rules are generally effective with respect to amounts deferred after 2004, many questions remain. The IRS is expected to provide additional guidance in the near future, but that guidance may not arrive soon enough to enable plan sponsors to make plan amendments before 2005. The IRS has indicated that it will provide some transitional relief. In the meantime, plan sponsors should familiarize themselves with the basic provisions of the new law. We will provide additional information as soon as it becomes available.

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Definition of Deferred Compensation

The new law defines a "nonqualified deferred compensation plan" as any plan that provides for the deferral of compensation. This definition includes both plans to which employees make elective contributions, and nonelective plans such as Supplemental Executive Retirement Plans (SERPs). In

addition, it applies to both defined contribution-type plans and defined benefit-type plans. Plans that cover individuals who are not employees (such as consultants and other independent contractors), as well as one person plans, are also subject to the new rules.

The definition does not include qualified plans (such as 401(k) plans), 403(b) plans and programs, section 457(b) plans, Simplified Employee Plans (SEPs), or SIMPLE plans. Bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans are also excluded from the definition of nonqualified deferred compensation plan.

In general, stock option plans (including ESOPs) and employee stock purchase plans are not affected by this new law. Stock appreciation rights are subject to the new law, but the IRS must issue regulations relating to these rights. IRS regulations are also expected to address the status of restricted stock and restricted stock units. We expect that IRS regulations covering these subjects will be issued within 60 days of enactment.

Deferral Elections

The new law provides a general rule regarding the timing of deferral elections. It also provides a rule that is applicable to “performance-based compensation.”

Generally, a participant must make an irrevocable election to defer compensation before the beginning of the taxable year in which the services are performed. A special 30-day election period applies to newly eligible participants and plans that are established mid-year.

Deferral elections for performance-based compensation, where the performance period is 12 months or more, may be made up to six months before the end of the services period. *For example, if a participant is entitled to a bonus payable in 2007, which is based on performance in 2006, the deferral election must be made by June 30, 2006.*

The law itself does not define the term “performance-based compensation.” However, it directs the IRS to publish applicable guidance, which may be similar to the guidance currently provided under Code section 162(m).

Distributions

Under the new law, nonqualified deferred compensation plans may only make distributions at:

- Separation from service,
- Disability (which is narrowly defined),
- Death,
- An unforeseeable emergency, or
- A specified time or under a fixed schedule specified in the plan.

Plans may not make distributions upon the occurrence of specified events, such as a child attending college.

Key employees of publicly-traded corporations must wait at least six months following separation from service to receive their distributions. For this purpose, the qualified plan top-heavy plan “key employee” definition applies.

Plans may also make distributions upon a “change in control” of the organization. While the law does not define the term “change in control,” it directs the IRS to publish regulations no more than 90 days following enactment, with instructions that the definition be more restrictive than the one currently used in the golden parachute rules.

The timing or schedule of any payment **may not be accelerated** except for changes in control, death, disability, or unforeseeable emergencies, and as provided in forthcoming IRS regulations. This new rule prohibits the use of so-called “haircuts” and other penalties for exercising withdrawal rights.

However, participants may make elections to further defer distributions. Such elections must be made at least 12 months before the date of the first scheduled payment. In addition, the delayed payment date must generally be at least five years from the original payment date. *For example, if an amount is originally scheduled to be distributed on December 31, 2007, an election to delay its receipt must be made by December 31, 2006. The new distribution date may not be earlier than December 31, 2012.*

Under the new law, payments cannot be triggered by a change in the financial health of the employer. If a change in the financial health of the employer triggers a payment or restricts assets to providing benefits under the nonqualified deferred compensation plan, the amounts involved in the transaction will be subject to taxation as if they were contributed to an offshore trust.

Penalties and Timing of Taxation

If the new rules are violated, “affected participants” are taxed immediately on the amount deferred. They are also subject to a 20% penalty and interest at the underpayment rate plus 1% as if the deferred compensation had been included in their income on the earliest date that they became vested in the benefit.

An “affected participant” is any person who receives nonqualified deferred compensation for the performance of services, including outside directors and consultants. In contrast to earlier proposals, the final law provides that violations will result in taxation only for the participant(s) who engaged in the violation and will not disqualify the entire plan.

Investment Options

The new law makes no changes regarding investment options that may be offered under nonqualified deferred compensation plans.

Effective Date and Grandfathering Provisions

The new law applies to amounts deferred under nonqualified plans after 2004. Earnings on deferred amounts are subject to the new rules only if the deferred amounts are subject to the new rules. For purposes of the effective date, an amount is considered deferred before 2005, if the amount is earned and vested before January 1, 2005.

Amounts deferred before 2005 are subject to special “grandfather” treatment. These amounts would only be subject to the new rules if a plan is “materially modified” after October 3, 2004.

While the law itself does not define the term “material modification,” the legislative history provides several helpful examples. The following changes are considered to be material modifications:

- The addition of a provision allowing distributions upon request, as long as the participant forfeits 10% of the amount of the distribution (a “haircut” provision);
- The acceleration of a vesting schedule;
- The addition of any benefit, right, or feature.

The following changes are *not* considered to be material modifications:

- A change in plan administrator;
- Removal of a distribution provision (e.g. to remove a “haircut” provision);
- Removal of an existing benefit, right or feature.

In addition, the law provides that a plan may be amended in accordance with IRS regulations to add the new rules for post-2004 deferrals without affecting the grandfathered status of pre-effective date deferrals. Also, a subsequent deferral election may be made for an amount originally deferred prior to 2005 without subjecting that amount to the new rules.

Next Steps

Employers should review the new rules, and develop an understanding of the key provisions and changes. It would be helpful to begin reviewing plan documents to determine if changes are required (for example, the removal of “haircut” provisions, as well as certain payment elections). We have prepared a chart that compares the major old and new law provisions, which may serve as a helpful starting point for this review.

Employers should also consider whether to amend existing plans or establish new plans for deferrals made after December 31, 2004.

The IRS is required to issue guidance relating to these new rules within 60 days of enactment. However, this timing could make it difficult for employers to make timely plan amendments. The IRS has informally stated that plan amendments will not be required until some time in 2005 and that transitional relief for deferral elections will be provided.

Finally, employers should take some formal action before the end of 2004 by an appropriate entity (Board of Directors or authorized committee) so that the necessary changes are approved in a timely manner.

We will provide additional guidance to employers when it becomes available.

Pension Analyst by Prudential Retirement

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