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Deferred Compensation Under the American Jobs Creation Act of 2004

Under the recently enacted American Jobs Creation Act of 2004 (the "Act"), a vested participant's deferred compensation under a nonqualified deferred compensation plan will be immediately included in the participant's gross income unless the plan satisfies certain requirements. In addition, the participant will be charged interest on the resulting tax liability from the year in which the compensation was initially deferred or the year in which the participant became vested, whichever is later. The participant will also be subject to a twenty percent penalty on the amount of the deferred compensation required to be included as income.

The Act applies to most plans that provide for the deferral of compensation and which are not tax-qualified. Thus, it covers plans sponsored by either taxable or tax-exempt employers; it applies to amounts deferred for employees and independent contractors; it includes any agreement or arrangement that defers the payment of compensation, including traditional nonqualified plans, stock appreciation rights, discounted stock options, SERPs, employment agreements, and other arrangements.

In general, the Act provides that compensation deferred under a nonqualified plan may not be distributed to a participant earlier than:

- separation from service (to be defined by the IRS in future guidance),
- disability (as defined in the Act),
- death,
- a specified time (or pursuant to a fixed schedule) set forth in the plan at the date of the compensation deferral (not upon the occurrence of an event),
- a change in control of the employer or in the ownership of a substantial portion of its assets (to be defined by the IRS), or
- the occurrence of an unforeseeable emergency (as defined in the Act).

In addition to providing an exclusive list of distribution events, the Act specifies that the time or schedule of any payments under a nonqualified plan may not be accelerated, except as the IRS may allow by regulation.

Moreover, according to the Act, a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election is made by the end of the preceding taxable year. (Limited exceptions are made for an employee's first year of eligibility to participate in a plan and for performance-based compensation. The IRS may provide additional exceptions by regulation.)

The time and form of distributions under the plan must be specified at the time of initial deferral. A plan may allow a subsequent election to delay the time or change the form of distributions. Such an election cannot be effective for at least twelve months after the date on which the election is made. The additional deferral must be for a period of at least five years from the date the payment would otherwise have been made (except in the case of a payment attributable to death, disability or an emergency). Any election related to a distribution to be made at a specified time must be made at least twelve months prior to the date of the first scheduled payment.

Finally, the Act restricts an employer's ability to fund its deferred compensation obligations without triggering the inclusion of such deferred compensation in the income of the participant. For example, the Act states that a transfer of property to the participant will be deemed to occur with respect to such compensation if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of such nonqualified deferred compensation, whether or not such assets are available to satisfy claims of general creditors.

The Act applies to compensation deferred after December 31, 2004, and the earnings on such deferred compensation. It also applies to amounts deferred prior to 2005 if the plan under which the deferral was made is materially modified after October 3, 2004, unless such modification is pursuant to transitional guidelines to be issued by the IRS. The Act applies in addition to the constructive receipt principles which have traditionally provided the basis for nonqualified deferred compensation plans.

There are a number of questions about the Act which remain unanswered. The IRS has been directed to promptly issue guidance on many of these matters, including certain transitional relief. In the meantime, it is important that employers take certain steps to respond to the Act and to prepare for the issuance of such guidance. Compliance with the Act is not optional. If at any time during a taxable year an employer's nonqualified deferred compensation plan fails to satisfy, or is not operated in accordance with, the Act's requirements, all compensation deferred under the plan for the taxable year, and all preceding taxable years -- as well as any earnings thereon -- will have to be included in the participant's gross income to the extent it is vested. In addition, interest and a twenty percent penalty will also be imposed. Thus, employers should:

-- Review all existing deferred compensation plans and identify those provisions that may be subject to the Act.

-- Review existing rabbi trust documents to determine whether they require funding of the trust upon a change in the employer's financial health.

-- Consider whether to amend existing plans to conform to the Act. Be aware that a "material modification" can cause a plan to lose its grandfathered status. Alternatively, consider the creation of new plans for post-2004 deferrals.

-- Communicate the new rules to plan participants.

-- Consult legal and tax advisors.

This advisory was written by Louis Vlahos, Esq., partner to the firm. Mr. Vlahos practices tax law and has extensive experience in corporate, individual and partnership income taxation, and in estate and gift taxation, including tax planning, ruling requests, and tax controversy.

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