



The Impact of The American Jobs Creation Act of 2004 on Deferred Compensation Arrangements

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Important Note: *The COLI illustration modules in the InsMark Illustration System should not be affected by The American Jobs Creation Act of 2004. It is the terms and conditions under which the benefits are granted and received that are affected by the Act -- not their numerical illustrations. InsMark's Documents On A Disk[®] ("DOD") System (Version 15.0 scheduled for release by April 2005) has multiple deferred compensation and severance documents, all of which have been revised to address the issues raised by The American Jobs Creation Act of 2004.*

The American Jobs Creation Act of 2004

General Items: Significant changes in non-qualified deferred compensation laws were included in The American Jobs Creation Act of 2004, hereinafter the "Act", which was signed into law on October 22, 2004. The provisions of the Act generally apply to amounts deferred after December 31, 2004 and to plans materially modified after October 3, 2004. The Act directed the IRS to provide guidance for interpreting and implementing the provisions of the Act within 60 to 90 days of when the legislation was passed. This included a limited transition period for amending current plans to meet the requirements of the Act.

The Act created Internal Revenue Code Section 409A. The requirements set forth in Section 409A were in addition to existing non-qualified deferred compensation requirements. The act imposed new rules, limitations and penalties. In general, the new law made deferred compensation plans more restrictive and less flexible.

In December 2004, the IRS issued Notice 2005-1, which gave further guidance on the transition to the new rules and clarification of some provisions of the Act. Notice 2005-1 was revised in early January 2005 to clarify certain transition rules. The Notice provides that a plan adopted before December 31, 2005, will not be treated as violating Section 409A only if (i) the plan is operated in good faith compliance with the provisions of Section 409A and the Notice during the calendar year 2005, and (ii) the plan is amended on or before December 31, 2005, to conform to the provisions of Section 409A with respect to amounts subject to Section 409A. A plan will be treated as operated in good faith compliance during the calendar year 2005 if it is operated in accordance with the terms of the Notice and, to the extent an issue is not addressed in the Notice, a good faith, reasonable interpretation of Section 409A.

Definition of Nonqualified Deferred Compensation: Section 409A provides that all amounts deferred under a non-qualified deferred compensation plan for all taxable years are currently

includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied. Nonqualified deferred compensation is broadly defined to include any plan that provides for payment of compensation at a time later than when services are performed, including “account balance” (defined contribution) plans, “nonaccount balance” (defined benefit) plans, and plans that are neither account balance or nonaccount balance plans. Nonqualified salary reduction, (non-disability) salary continuation, SERP, “Ineligible” Section 457(f), and discount or phantom stock plans are subject to the provisions of Section 409A.

Nonqualified deferred compensation may also include severance pay plans. The IRS has solicited comments from tax professionals on how Code Section 409A should apply to severance pay plans. Until further guidance is given, a plan that provides severance pay benefits, meets the ERISA definition of a severance plan, and in good faith complies with the other provisions of Code Section 409A will not be deemed to violate the provisions of Section 409A during the calendar year 2005, provided the plan is a collectively-bargained plan or covers no key employees as defined by Code Section 416(i). If key employees are covered under the plan, full, good faith compliance with the provisions of Code Section 409A is required. Key employees are defined under Code Section 416(i) as: i) an officer of the employer having an annual compensation greater than \$130,000 (adjusted for inflation in \$5,000 increments after 2001), (ii) a 5-percent owner of the employer, or (iii) a 1-percent owner of the employer having an annual compensation from the employer of more than \$150,000.

For purposes, of Section 409A, non-qualified deferred compensation does not include qualified plans, tax deferred annuities, “eligible plans” under Code Section 457(b), simplified employee pensions, or SIMPLE plans. The rules of Section 409A do not apply to bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. Deferred compensation does not include amounts paid shortly after the period in which services were performed. For example, a normal salary payment made after the first of the year for services rendered at the end of the year or an annual bonus paid within the first 2 1/2 months after the year in which services were performed.

Note to Licensees of the InsMark Loan-Based Deferred Compensation System: In spite of its name, the InsMark Loan-Based Deferred Compensation System does not illustrate deferred compensation arrangements; it illustrates loan-based split dollar arrangements funded by non-recoverable salary forfeitures. The loan to the Executive is a genuine liability that must be repaid, and the arrangement should arguably be ruled by the Split Dollar Regulations issued in September 2003, not The American Jobs Creation Act of 2004. For further details on this issue, see Marketing Alert #166 (December 2004).

Severance benefits are ruled by Section 409; however, the optional severance benefit associated with Loan-Based Deferred Compensation should not present compliance issues if appropriate rules are followed. See the severance section of InsMark’s Documents On A Disk (Version 15.0 or higher). Always be certain that your client’s legal and tax advisers agree before installing the InsMark Loan-Based Deferred Compensation System for a client or including a severance benefit as part of the arrangement.

Substantial Risk of Forfeiture: Compensation subject to a substantial risk of forfeiture is not considered deferred compensation and, thus, is not governed by Code Section 409A. For Section 409A purposes, compensation is considered to be subject to a substantial risk of forfeiture if the

right to receive the compensation is conditioned on the performance of substantial future services or the occurrence of certain conditions, and the possibility of forfeiture is substantial. Any addition of a substantial risk of forfeiture after the service period begins or any extension of the substantial risk of forfeiture period is disregarded for purposes of determining whether compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services.

The Treasury Department and the IRS have expressed a concern about arrangements purported to involve a substantial risk of forfeiture and fixed payment date where the parties do not intend for the substantial risk of forfeiture or fixed payment date to be enforced. Accordingly, the Treasury Department and the IRS are considering a more restrictive rule under which arrangements involving payments in later taxable years structured to coincide with a lapse in a substantial risk of forfeiture would constitute deferrals of compensation subject to Section 409A. However, even under a more restrictive rule, the Treasury Department and the IRS anticipate that a payment within a short period following a scheduled vesting date may be permitted, if otherwise consistent with Section 409A. The IRS has requested comments with respect to these issues and the extent to which additional guidance is required to prevent arrangements designed to evade application of Section 409A.

The Act created additional constructive receipt rules, plus rules relating to plan limitations and penalties.

Constructive Receipt: In addition to existing rules relating to constructive receipt, economic benefit, and assignment of income, which continue to apply, the Act added rules relating to distributions, acceleration of benefits, and deferral elections:

Distributions. The Act specifies certain acceptable events that can “trigger” a distribution. It allows a plan participant or his/her designated beneficiary to begin receiving benefits only: (1) upon separation from service; (2) on the date the participant becomes disabled; (3) at death; (4) at a time, age, or schedule specified in the plan at the time of deferral; (5) upon a change of company ownership; or (6) upon the occurrence of an unforeseeable emergency. Benefit payments to high level executives of publicly traded corporations due to separation from service may not begin for at least 6 months after the separation from service occurs.

Acceleration of Benefits. In general, no acceleration of payments under the plan are permitted unless specifically allowed by regulation. A participant may be given a choice between taking a lump-sum or an annuity payout. Certain exceptions to the general rule are provided for: (1) distributions beyond the participant’s control; (2) withholding taxes; (3) certain distributions to pay taxes; and (4) distributions of de minimis (small) amounts for non-key employees.

Elections to Defer. Certain rules apply to initial deferrals. An initial election to defer must be made before the year in which services are rendered; an election by a newly eligible employee is valid if made within 30 days of the date of eligibility; and, in the case of performance-based compensation, the deferral election must be made at least six months before end of the 12-month period in which the services are performed.

Certain other rules apply to elections that modify the time and/or form of distribution. For plan provisions that permit subsequent elections that would postpone the receipt of or alter the form of payment, the plan must provide that: an election is not effective until at least

12 months after the modifying election is made; elections relating to distributions for separation from service, at a specified time or when a change in ownership or effective control occurs, must provide for a deferral of at least five years; and deferral elections with respect to a specified time must be made at least twelve months in advance.

Plan Limitations and Penalties: *Funding Limitations.* The Act imposes certain funding restrictions for non-qualified deferred compensation plans, the violation of which causes immediate taxation, assessment of interest at the IRS “underpayment rate” plus 1%, and triggers a 20% penalty.

Non-Standard “Triggers”. Certain non-standard “trigger” provisions are prohibited, especially for triggers related to a change in the employer’s financial health. Off-shore “rabbi” trusts, which permit the employer to set aside assets outside the United States, are also prohibited.

Penalty Provisions. In addition to the immediate inclusion of income and back interest due when the provisions of the Act are violated, the Act imposes a penalty equal to 20% of the amount included in income as a result of not meeting all the requirements of the law.

Withholding. Withholding is required on amounts included in income. Deferred amounts, though not taxed currently, must be reported on the employee’s W-2 for informational purposes and are subject to FICA withholding for vested, deferred amounts.

Important Note: *The material in this report is for educational purposes only. In all cases, the approval of a client’s legal and tax advisers must be secured regarding the implementation or modification of any deferred compensation or severance arrangement as well as the applicability and consequences of new cases, rulings, or legislation upon existing or impending plans.*