VENABLE LLP
Not-for-Profit Alert
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New Rules on Nonqualified Deferred Compensation Require Immediate Review of Existing Plans

On October 11th, Congress passed the American Jobs Creation Act of 2004, a comprehensive new tax bill, which President Bush signed into law on October 22nd.

Among many other changes, the Act creates a new, more restrictive set of rules governing the taxation of nonqualified deferred compensation, which applies to all employers, *including trade associations, not-for-profits and governmental employers*. The new rules will affect nonqualified deferred compensation that accrues or vests after December 31, 2004. However, the new rules will not apply to "eligible" deferred compensation plans under Section 457(b).

While the new rules will present new challenges for trade associations, not-for-profits and governmental employers, nonqualified deferred compensation will remain a valuable compensation technique.

This Client Alert provides a brief overview of the new rules as they apply to trade associations, not-for-profits and governmental employers and suggests steps tax-exempt and governmental employers should take in the coming months to make sure that their nonqualified deferred compensation plans comply with the new rules.

Overview of Changes to Deferred Compensation

In the case of tax-exempt and governmental organizations, the new rules will primarily affect elections to defer the receipt of compensation, as well as elections regarding the time and manner in which deferred compensation is paid. The rules also limit offshore funding arrangements and the use of so-called rabbi trusts to fund deferred compensation where the funding is triggered by changes in an employer's financial health.

Significantly, these rules are in addition to the rules currently in effect for "ineligible" deferred compensation arrangements under Section 457(f).

While the new rules in the Act are quite complex, here are some key features of the changes that will affect most nonqualified deferred compensation plans that are sponsored by tax-exempt and governmental employers:

Deferral elections – Under the new rules, an election to defer compensation generally must be made *prior to* the start of the year in which the services for which the compensation is earned are performed. In practical terms, this means that because of the Act's effective date, an election to defer compensation for services to be performed in 2005 must be made *no later than December 31, 2004*.

There are two important exceptions to this rule. First, in the case of a new deferred compensation plan or the first year of a participant's eligibility under an existing plan, a deferral election may be made within 30 days after the date the plan is adopted or the participant first becomes eligible to participate. Second, deferral elections with respect to "performance based" compensation must be made at least six months prior to the end of the period over which performance is measured. It is expected that the Treasury Department will issue guidance about what standards must be met in order for compensation to be considered "performance based."

Distribution Restrictions – Under the new rules, elections regarding the time and form of payment of deferred compensation must be irrevocable and set forth in a written plan or agreement, or agreed to by the participant in writing at the time the compensation is initially deferred. In addition, the new rules impose restrictions about the circumstances in which deferred compensation may be paid. Under the rules, payments of deferred compensation may only be made on a fixed date (or according to a fixed schedule) or in connection with a separation from service, death, disability, an unforeseeable emergency, or a change in control of the employer.

Once the time and form of payment have been elected, changes to that election are permitted only if (1) the subsequent election is not effective for at least 12 months, (2) if the subsequent election relates to a payment due on a fixed date (or according to a fixed schedule), the election is made at least 12 months before the first payment is due, and (3) the subsequent election defers the payment for a period of at least 5 years (unless the change relates to a payment on account of disability, death or an unforeseeable emergency).

No Acceleration – One of the more significant changes in the new rules provides that a nonqualified deferred compensation arrangement may not permit acceleration of the time or schedule of any payment, except as specifically authorized by the IRS in regulations (yet to be issued). This provision effectively eliminates "haircut" provisions, which under prior law permitted such accelerations if the person entitled to receive the deferred compensation either gave up some portion of the deferred amount or agreed to forego potential future appreciation or investment income with respect to the deferred amount.

No form of "acceleration" discretion – including employer discretion – is permitted. This includes "discretion" to amend or terminate a plan and accelerate payments. Consequently, deferred compensation plans will now need to be "hard wired" – in other words, the plan document will need to preclude employer and employee discretion as to the timing of payments, and the document will need to provide exactly when and under what circumstances deferred compensation will be paid. In informal discussions, the Treasury Department has indicated that the Act is intended to force employers and employees to live with the deferred compensation choices they make.

Funding Restrictions – The new rules preclude employers from transferring assets set aside to pay deferred compensation outside the U.S. Also, it is not permissible to provide that, upon a change in the financial health of the employer, amounts will be set aside in a rabbi trust to pay deferred compensation. It is important to note that the mere inclusion of a financial health clause triggers the sanctions, even if the rabbi trust is never actually funded.

The new rules only affect rabbi trusts with financial triggers. They do not eliminate traditional rabbi trusts – even rabbi trusts that spring into existence on a change in control.

Sanctions for Failure to Comply – If a nonqualified deferred compensation arrangement fails to comply with the new rules, vested amounts (or amounts set aside in violation of the funding restrictions) will be subject to income taxes. In this respect, the application of new rules is not materially different than the result obtained by Section 457(f) with respect to ineligible deferred compensation arrangements. However, the new rules also "up the ante" in two important respects. If the arrangement fails to qualify, vested amounts will also be subject to (1) a new 20% excise tax and (2) an additional amount equal to the IRS underpayment interest rate, plus 1% (with interest calculated beginning as of the later of the date that the compensation was deferred or became vested).

Types of Arrangements Covered – The new rules affect:

- SERPs.
- 401(k) wrap around plans.
- Bonus and incentive deferral plans.
- Elective deferral arrangements.
- Other deferred compensation subject to Section 457(f).
- Severance pay.

The new law gives the IRS the ability to ignore a substantial risk of forfeiture that is illusory or is inconsistent with the purpose of the new rules. The ability of the IRS to ignore a substantial risk of forfeiture is likely to eliminate the

ability to delay taxation of "ineligible" deferred compensation under Section 457(f) through the use of a rolling risk of forfeiture. Tax-exempt organizations that have arrangements with a rolling risk of forfeiture will need to carefully monitor IRS guidance to determine how to address this issue.

Types of Arrangements Not Covered – The new rules do not affect:

- Eligible deferred compensation plans under Section 457(b).
- Tax-qualified plans.
- Section 403(b) tax-sheltered annuities and custodial accounts.
- Simplified employee pensions and SIMPLE plans.
- Governmental excess plans under Section 415(m).
- "Bona fide" vacation leave, sick leave, compensatory time, disability, and death benefit plans.
- Arrangements that do not involve a "deferral" when the compensation vests.

Effective Date – The new rules apply to any deferred compensation that is not vested on December 31, 2004. The new rules do not apply to compensation deferred prior to 2005, as long as the arrangement is not "materially modified" after October 3, 2004. For this purpose, an acceleration of vesting or payment will be treated as a material modification.

The application of the new rules to compensation that was deferred previously, but which is not vested as of December 31, 2004, is problematic for "ineligible" deferred compensation arrangements of tax-exempt or governmental organizations. Most "ineligible" arrangements have been structured so that the deferred compensation is not vested (in order to delay taxation) under Section 457(f). Consequently, the new rules will apply to SERPs and other forms of ineligible deferred compensation of tax-exempt organizations, even though the compensation was deferred long before the January 1, 2005 effective date.

The new law directs the IRS to issue guidance within 60 days of enactment that will allow existing deferred compensation plans (to the extent not grandfathered) the option of conforming to the new rules or being taxed on the amount deferred (to the extent vested). In informal discussions, the Treasury Department has indicated that it will meet this deadline and that it will provide "liberal" transitional relief.

What steps should an employer take to prepare for the new rules?

- Inventory all nonqualified deferred compensation plans that could be affected by the new rules.

- Determine what impact the new rules will have on the design of existing plans and elections – i.e., are there "haircut" withdrawal provisions that will need to be eliminated? Rabbi trust provisions that need modification? Distribution limitations that need to be imposed?

- Determine what impact the new rules will have on plan design.

- Ensure that 2005 deferral elections for existing plans are made by December 31, 2004.

- Consider whether existing plans should be amended or new plans established. Prior to adopting a post October 3, 2004 amendment to an existing deferred compensation arrangement, consider whether the amendment would "materially modify" the arrangement (thereby triggering application of the new rules).

- Maximize deferrals under 401(k), 403(b) and eligible Section 457(b) plans before deferring compensation under a Section 457(f) arrangement.

The new rules are complex and involve a fundamental change in the way many deferred compensation arrangements of tax-exempt and governmental employers will work. Venable is ready to assist you in understanding the implications of the new law and in implementing the necessary changes to your nonqualified deferred compensation plans. Please contact any of the following members of Venable for assistance or with any questions:

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