

"[A]n employee may make an election as late as March 15, 2005, to defer compensation for services performed on or before December 31, 2005."

Beware the Ides of March: Voluntary Deferral Elections for 2005 Must Be Made by March 15

by
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Under new rules for nonqualified deferred compensation, employees' elections to defer compensation for services they perform on or before December 31, 2005, must be made by March 15, 2005. The new rules – which were added by the American Jobs Creation Act of 2004 (the "AJCA") – generally require that elections to defer compensation be made by December 31 of the year preceding the year in which the services are performed for which the compensation would otherwise be paid. So, for example, under this general rule, elections would need to be made by December 31, 2004, to defer bonuses paid for 2005 services, even if those bonuses would not be determined and paid until 2006.

But, under special transition relief provided by the IRS, an employee may make an election as late as March 15, 2005, to defer compensation for services performed on or before December 31, 2005. To be entitled to take advantage of this special rule, several conditions must be satisfied. First, the amounts to which the deferral election relate must not have been paid or become payable at the time of the election. Second, the plan under which the deferral election is made must have been in existence on or before December 31, 2004. Third, the plan must be amended by December 31, 2005, to comply in all other respects with the new nonqualified deferred compensation rules, and must be operated to otherwise comply with the new rules. The plan must be operated in compliance with the new rules even in 2005, subject to certain transition rules. Finally, the plan must be amended by December 31, 2005, to provide for the elections (and the elections must otherwise be in accordance with the terms of the plan in effect on or before December 31, 2005).

As noted, to make use of the rule permitting deferrals of 2005 compensation to be made as late as March 15, 2005, a plan must have been in existence on or before December 31, 2004. A plan will be treated as in existence before December 31, 2004, only if a written plan document (a) identifies a specific amount of type of compensation that is subject to the plan and not otherwise payable at the time of the deferral election, and (b) provides that a participant in the plan may elect to defer compensation beyond the year in which the amount otherwise would have been payable.

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Compensation Subject to AJCA Rules. The new deferral compensation provisions of the AJCA restrict the deferral of compensation in many ways other than setting deadlines for voluntary elections to defer compensation. These additional rules apply not only to voluntary deferrals, but also to compensation an employer chooses to defer, without any employee election, such as benefits under a supplemental executive retirement plan ("SERP") designed to supplement an employer's qualified retirement plan. The new rules also apply broadly to many other types of deferred compensation, including deferrals under individual employment agreements. The rules can even apply to deferred compensation arrangements with independent contractors.

The rules generally do not apply to annual bonuses (or other annual compensation) paid within two and one-half months after the end of the calendar year in which the services were provided for which the bonuses (or other compensation) are paid. The new rules can, however, apply to annual bonuses paid more than two and one-half months after year-end, as well as to severance pay.

Here are some of the other rules the AJCA imposes on deferred compensation arrangements:

Events Triggering Distribution. Under the AJCA, deferred compensation may not be distributed earlier than:

- **Separation from Service**
- **Disability**
- **Death**
- A "**Specified Time (or pursuant to a Fixed Schedule)**" specified under the plan at the date of the deferral of compensation
- A **Change in Ownership** or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, as provided in Treasury regulations
- The occurrence of an **Unforeseeable Emergency**

Specified Time. As noted in the list above, payments under a nonqualified deferred compensation plan may be made at a "specified time." The legislative history for the AJCA indicates that amounts payable upon the occurrence of an event are *not* to be treated as payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event and not at a specified time. It is likely that payment at the time distribution is made under an employer's 401(k) or other qualified retirement plan (such as a defined benefit pension plan or profit sharing program) would not be considered payment at a specified time or pursuant to a fixed schedule, and therefore would not satisfy the new requirements of the AJCA.

Disability. A participant is disabled for purposes of the distribution rules if the participant (a) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected

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to result in death or can be expected to last for a continuous period of not less than 12 months, or (b) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident or health plan covering employees of the employer.

Unforeseeable Emergency. For purposes of the distribution rules, an "unforeseeable emergency" is a severe financial hardship to a participant resulting from an illness or accident of the participant, the participant's spouse, or a tax dependent of the participant; a loss of the participant's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. In the event of an unforeseeable emergency, the amount distributed must not exceed the amount necessary to satisfy the emergency, plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which the hardship is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the participant's assets (to the extent the liquidation of those assets would not itself cause severe financial hardship).

Acceleration of Benefits. No acceleration of benefits or the payment of benefits is permissible, except as permitted under Treasury regulations. The IRS has, in Notice 2005-1, indicated that a plan may permit the acceleration of the payment of benefits to an individual other than the participant (such as to a former spouse) as necessary to satisfy a domestic relations order, and may permit the acceleration of distribution to the extent necessary to pay FICA taxes on the deferred compensation and to pay any related withholding tax on those FICA amounts.

Deferral Election Timing Rules. In general, elections to defer compensation for services rendered during a year must be made no later than the close of the preceding year. This rule applies to voluntary deferrals of compensation, such as under typical bonus deferral programs or 401(k) tandem plans. It appears that similar timing rules apply to compensation an employer chooses to defer for its employees (without employees making a voluntary election to defer), if those employees have a choice as to when and how distribution is made. Those elections as to the timing and form of distribution would appear to be subject to the new election deadlines.

The general rule that deferral elections must be made before the beginning of the year in which the employee's services are provided is relaxed for the first year in which a participant becomes eligible to participate in a deferred compensation plan. In that event, a participant may make an election within 30 days after the date he or she becomes eligible. Even then, however, the election may only be made with respect to services to be performed subsequent to the election.

There is another special rule, which may be of use under bonus deferral programs. Where performance-based compensation is based on services performed over a period of at least 12 months, a participant's deferral election may be made as late as six months prior to the end of the service period. So, for example, for

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performance-based bonuses based on services performed over a calendar year, deferral elections could be made as late as June 30 of the year during which the services are performed. The IRS has issued some temporary guidance – which it has indicated is probably more generous than later guidance will be – permitting use of this special six month election timing rule with respect to bonus compensation where (1) payment of the compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria, and (2) the performance criteria are not substantially certain to be met at the time a deferral election is permitted. Bonus compensation may include payments based upon subjective performance criteria, but (1) any subjective performance criteria must relate to the performance of the participant, a group of employees that includes the participant, or a business unit for which the employee provides services (which may include the entire organization), and (2) the determination that any subjective performance criteria have been met must not be made by the participant or a family member of the participant. The special six month deferral election timing rule is unavailable for any amount that is paid based upon a level of performance that is substantially certain to be met at the time the criteria are established, or that is based solely on the value of, or appreciation in value of, the employer or its stock.

Certain Changes in Distribution Elections Permitted. In the case of voluntary deferrals (and perhaps non-voluntary deferrals), participants may be permitted to make later elections to further defer (but not accelerate) distribution in certain circumstances. Under these rules, later elections to delay a payment or change the form of a payment may be made if:

1. The plan requires that the later election not take effect until at least 12 months after the date on which the election is made;
2. In the case of an election relating to a payment that is not on account of disability, death, or unforeseeable emergency, the plan requires that the first payment with respect to which the election is made be deferred for a period of at least five years from the date the payment would otherwise have been made; and
3. The plan requires that any election relating to a payment to be made at a specified time (or pursuant to a fixed schedule) not be made less than 12 months prior to the date of the first originally scheduled payment.

Consequences of Failing to Meet New Rules. Amounts deferred under a nonqualified deferred compensation plan that does not meet the new requirements will be taxed to the extent they are not subject to a substantial risk of forfeiture. For many plans, this will cause participants to be taxed when they vest. In addition to current income inclusion, interest at the Tax Code's underpayment rate plus one percentage point will be imposed on underpayments that would have occurred had the compensation been properly reported as taxable when first deferred or, if later, when no longer subject to a substantial risk of forfeiture (typically, when participants vest). In addition, the amount required to be included in income is subject to a 20 percent additional tax.

Effective Date of New Rules. The new rules are technically effective for amounts deferred after December 31, 2004. The IRS has, however, issued

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transition relief (discussed below). For purposes of the rules' effective date, amounts are treated as deferred on or before December 31, 2004 – and therefore not subject to the new rules – only if the employer has a binding legal obligation to pay those amounts in a future year and a participant's right to those amounts is earned and vested as of December 31, 2004. In most cases, the result of this rule will be to apply the new rules to amounts that are not vested by December 31, 2004. Earnings on amounts deferred before January 1, 2005, also are not subject to the new rules.

Transition Rules. In general, plan amendments necessary to conform deferred compensation arrangements to the AJCA rules need not be adopted until December 31, 2005. In fact, there is probably some advantage in waiting until later in the year before adopting amendments. That is because we expect to receive additional guidance from the IRS during the course of 2005, further explaining the new rules.

Terminating Plan. The new AJCA rules grant employers a number of options in dealing with the new requirements. One option is to terminate plans by December 31, 2005, with distribution of amounts held in those plans being made in 2005 and with participants being taxed that year. This generally would not be a sound approach for an employer if its goal remains to defer taxation on amounts held under its plan. In any event, before terminating a plan, an employer must consider whether termination of the plan with early distribution of benefits would violate the terms of the plan and, if so, whether those provisions can be amended to make termination and early distribution permissible.

New Distribution Elections. More helpfully, a plan can be amended by December 31, 2005, to permit participants to make new elections concerning when and how previously deferred amounts will be distributed, if those previously deferred amounts are subject to the new rules. These elections would need to be made by December 31, 2005.

Cancellation or Reduction of Deferral Elections. A plan can also be amended to allow participants, during 2005, to cancel or reduce deferral elections for amounts subject to the new rules. The amounts no longer deferred would then be taxable to the participant in 2005.

Grandfather Rule for Elections Made by March 15, 2005. Under the rules described earlier, elections made by March 15, 2005, are not subject to the new election timing rules, if certain requirements are met. The new rules on when and how distribution can be made would, however, continue to apply.

We have described here only a portion of the complex new requirements for deferred compensation. In doing so, we have simplified certain rules and failed to mention others. As a result, and because these materials provide information only of a general nature, it is important that you consult with legal counsel before taking action. In particular, it will be important to consider your organization's particular circumstances before making any decisions relating to your organization's plans. Those circumstances may affect the legal conclusions discussed in this newsletter, as well as the approach best suited for your organization.