

December 2004

*The tax attorneys at Lindabury provide a full complement of services in virtually all types of tax matters for individuals, partnerships, family businesses including privately-held corporations, charitable organizations, and publicly-owned corporations.*

*The firm's practice includes tax planning, as well as representation before the Internal Revenue Service, Federal and State tax courts, county boards of taxation, and various other state and local tax authorities.*

New Jersey Office  
P. O. Box 2369  
53 Cardinal Drive  
Westfield, NJ 07091  
908-233-6800  
Fax 908-233-5078  
info@lindabury.com

New York Office  
Suite 2300  
26 Broadway  
New York, NY 10004  
212-742-3390  
Fax 212-269-5016  
info@lindabury.com

[www.lindabury.com](http://www.lindabury.com)

FIFTIETH ANNIVERSARY

1954  2004

## Changes to Executive Deferred Compensation Plans

*"Amend plan now, or cry in your beer." Anonymous*

**By Robert S. Schwartz**

The recently enacted American Jobs Creation Act of 2004 introduced Section 409A to the Federal Internal Revenue Code. The subject matter of Section 409A is company deferred compensation plans or arrangements. If your company has a deferred compensation plan (whether oral or written), read on. If not, you may still wish to learn about this important tax law change.

A deferred compensation plan or arrangement is any program whereby a given amount of earned compensation that could have been received by a business owner or executive or other highly compensated employee for a given year, in fact, was not received during that year, but rather receipt was deferred until some future specified time or times or specified events, so that the income taxation of that "deferred compensation," plus future earning on that compensation, is delayed until ultimate receipt by the plan participant or his beneficiaries. These plans are very widespread in the United States today.

Section 409A, generally effective January 1, 2005, ends a twelve-year standoff between the IRS and deferred compensation plan owners. Short of jail time, the tax penalties to executives for deferring executive compensation after 2004 that is not in compliance with the new requirements and limitations of Section 409A are very harsh. We have been engaged to rewrite plans to conform to the new tax law at this time as a result of these potential tax penalties.

What follows is a non-exhaustive discussion of new Section 409A.

*over (➡)*



**Robert S. Schwartz** provides advice and counsel to companies, organizations and individuals regarding corporate, business and tax matters. He is currently the Chair of the Tax Section of the New Jersey State Bar Association. He can be reached at [rschwartz@lindabury.com](mailto:rschwartz@lindabury.com).



## NON-QUALIFIED DEFERRED COMPENSATION PLANS (IRC 409A)

- A. Effective for amounts deferred on or after January 1, 2005, all amounts deferred under a non-qualified deferred compensation plan for all taxable years are includible in gross income, on a current basis, to the extent they are not subject to substantial risk of forfeiture (as defined by IRC 83), unless new specific requirements are met.

Some of the new requirements are as follows:

- Distributions (from deferred compensation funds) are allowed only upon separation from service, death, change in control, disability, unforeseeable emergency or finally, pursuant to a fixed schedule or predetermined dates for distribution.
  - The last of these must be specified at the time of elective deferral.
  - A plan must provide that the compensation for services performed during a given calendar year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding calendar year (for the first year an employee becomes eligible for participation, the election may be made within 30 days after the date the employee becomes initially eligible.)
  - In the case of any so-called "performance-based compensation," based on services performed over a period of at least 12 months, the deferral election must be made no later than 6 months before the end of the identified performance based service period.
- B. Transfers of funding assets to foreign trusts as part of deferred compensation arrangements result in those assets becoming taxable to the participants. Any subsequent increases in value or earnings with respect to trust assets are treated as additional taxable income.
- C. If the new rules are not followed, interest at the IRS under-payment rate, plus 1 percentage point that is imposed on tax under-payments, is added on top of the income taxes that would have been incurred had the amounts deferred been includible in income for either the calendar year in which first deferred or, if later, the first calendar year not subject to a substantial risk of forfeiture, as the case may be. The amount

required to have been included in income, but was not, is also subject to an additional 20% of the improperly deferred compensation excise tax.

- D. Deferred compensation amounts are required to be included in annual employer information reporting. Thus, the total amount of an employee's deferrals under a non-qualified deferred compensation plan for a given year will be shown on Form W-2, Box 12, using Code Y. Also, federal income tax withholding requirements are imposed on employers with respect to distributions after deferral.
- E. Once deferred, distributions of deferred amounts may be delayed by subsequent deferral elections, subject to the following limitations:
- A subsequent deferral election relating to any kind of previously deferred payments cannot take effect until at least 12 months after the subsequent deferral election is made.
  - A subsequent deferral election, relating to previously deferred payments to be made on previously elected dates or according to a previously elected schedule, cannot be made less than 12 months before the first of the series of the previously elected dates or schedule.
  - A subsequent deferral election to further defer payments to be made (1) upon a separation from service, (2) upon a change in ownership or (3) upon predetermined dates or schedule must defer the payments for at least an additional 5 years.
- F. The new requirements do not apply to the following plans or arrangements: those that comply with the tax law prior to change and that are not "materially modified" after October 3, 2004 with respect to amounts deferred before January 1, 2005. Accordingly, there can be, and, in nearly all cases, there will have to be to protect pre-existing deferrals, a "freezing" of existing plans and participant accounts and the adoption of new plans and setting up of new accounts, effective January 1, 2005, which comply with the new rules of Section 409A.



*The information provided here is necessarily general and is not intended as legal advice or a substitute for legal advice. If you have any questions regarding this Alert, please contact Bob Schwartz at [rschwartz@lindabury.com](mailto:rschwartz@lindabury.com).*