

Nonqualified Deferred Compensation – Final Regulations

The IRS recently issued final regulations under Internal Revenue Code §409A implementing the major changes to the tax treatment of nonqualified deferred compensation plans (NQDPs) and similar arrangements that were enacted by the American Jobs Creation Act of 2004. Prompted by corporate scandals at Enron and other companies, §409A imposes significant restrictions and limitations on the design and operation of NQDPs and similar arrangements. Failure to comply with §409A subjects the employee to income tax on all deferred compensation when earned (or vested, if later), plus interest on the tax retroactive to the date of vesting, plus an additional 20% penalty on the amount of deferred compensation – a hefty price to pay for non-compliance. The regulations require adoption of conforming amendments to NQDPs and similar arrangements by the end of 2007.

Take note that the scope of §409A is very broad. In general, deferred compensation results if the employee has a legally binding right to compensation that is payable in later years. As a result, §409A applies to supplemental executive retirement plans (SERPs), nonqualified Section 457 plans, stock options and stock appreciation rights that are granted at less than fair market value, as well as to individual employment or severance agreements which include salary or bonus deferral provisions. Application of §409A is not limited to employer/employee arrangements, but also applies to independent contractors, members in limited liability companies, and to partners in partnerships.

Qualified retirement plans, tax deferred annuities, simplified employee pensions (SEPs) and SIMPLE retirement accounts are exempt from §409A, as are bona fide vacation, sick, and personal leave plans. Disability pay, death benefit, and certain severance plans are also exempt from §409A. There is also an important exception to §409A for short-term deferrals: no deferral of compensation results if the employee receives the compensation within 2-1/2 months after the year in which the employee's right to payment vests.

The §409A rules generally apply to amounts deferred after December 31, 2004. Amounts deferred and vested prior to January 1, 2005, and earnings on those amounts, are not subject to §409A, unless the NQDP is materially modified.

In order to comply with §409A, deferral elections must generally be made prior to the beginning of the calendar year in which the compensation is deferred, or within 30 days of the employee becoming eligible for participation in the NQDP. If the award is performance-based (i.e., an incentive bonus), the election must be made no later than six months before the end of the performance period. Although the timing and form of distribution must be specified at the time of the initial deferral election, employees are permitted to select multiple distribution events and multiple forms of benefits for different events. A NQDP may not permit distributions earlier than the employee's separation from service, death, disability, a specified time (or pursuant to a fixed schedule), a change in control of a corporation (to the extent allowed by the regulations), or an occurrence of unforeseeable emergencies. Key employees of a publicly traded corporation generally cannot receive a distribution earlier than six months following termination of employment. Once made, elections regarding the timing of distributions cannot be accelerated (i.e., "haircut" provisions under which individuals forfeit 10% or some other portion of their benefit in exchange for access to their benefit are prohibited). Any subsequent election to modify or delay distributions and arrangements: (a) may not be made less than 12 months before the first scheduled payment, (b) cannot take effect for at least 12 months after the subsequent election, and (c) in the case of separation from service or change in control, must delay the initial payment by at least five years.

Although §409A continues to permit the use of rabbi trusts (trusts that are subject to the claims of general creditors) in connection with NQDPs, offshore rabbi trusts are generally prohibited.

The following steps should be taken right away: (1) identify deferred compensation plans and arrangements which are within the scope of §409A; (2) review those plans and arrangements for compliance with §409A; (3) amend the plans and arrangements by December 31, 2007 to conform to the final regulations, and (4) operate the plans and arrangements in compliance with §409A. Please contact us for assistance in this regard.



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Bruce E. Babcock

Bruce Babcock has over 24 years of experience in tax planning for corporations, partnerships, limited liability companies and individuals in a wide variety of transactions, including mergers and acquisitions. He also advises taxpayers and qualified intermediaries with respect to tax-free exchanges of real and personal property. Bruce has partnered with clients to form non-profit corporations, and successfully obtained determinations from the Internal Revenue Service (IRS) of their tax-exempt status. He has represented entities and individuals before the Utah State Tax Commission and the IRS, including private letter ruling requests, audits, formal and informal hearings, appeals conferences, United States Tax Court and Claims Court proceedings.

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