



Deferred Compensation Revolution

December 2004

Effective January 1, 2005, all non-qualified deferred compensation plans, old and new, must comply with a new set of statutory rules. This will require, among other things, amending many plans and educating employees and employers on all of the new rules. Failure to satisfy the new rules will affect all of the compensation deferred under the plan from its inception. Failure may: (1) result in immediate taxation of all compensation deferred under the plan, (2) add an extra 20% tax and (3) add interest from the date the compensation is first includible in income under the new rules.

If you have an existing non-qualified deferred compensation plan, it must comply with the new rules beginning January 1, 2005, but the IRS issued guidance on December 21, 2004 creating a transition period for existing plans. Existing plans may be amended to comply with the new rules, and those plans may provide existing participants with an election to terminate participation in the amended plan or to cancel a deferral election for amounts deferred after December 31, 2004. The transition period for amending existing plans and giving participants the right to opt-out of the new rules ends December 31, 2005. In addition, if an existing written plan requires an employee election to defer compensation earned after December 31, 2004, that election to defer must be made **no later than March 15, 2005** (except for certain performance-based bonuses). The

March 15th election date may affect any number of deferred compensation plans, including bonus deferral plans. Unwritten plans requiring employee elections are problematic after December 31, 2004, but there are some planning possibilities.

The new rules apply to any plan that provides for the deferral of compensation after December 31, 2004 ("New Money"), other than a qualified employer plan and any bona-fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. Plans subject to the new rules include Stock Appreciation Rights, Phantom Stock Plans, Supplemental Executive Retirement Plans (SERP's), Deferred Equity Rights Agreements, some severance programs, some non-qualified stock option plans, most non-qualified 457 Plans and, in general, any non-elective or employer-funded deferral arrangements. The rules also apply to arrangements between partners and a partnership and between a service recipient and an independent contractor.

Beginning in 2005, there are specific requirements and limitations on elections to defer and to re-defer, specific limitations on distributions and funding, and a new reporting requirement.

When a plan requires an employee election to defer income, after December 31, 2004, that election to defer compensation must be made prior to the end of the previous tax year -- failure to make the

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election timely will result in the income being taxed immediately. There are three exceptions: (1) a 30-day grace period is allowed for new participants in a plan, (2) an election to defer performance-based compensation need be made only 6 months before the end of a performance period, provided that the performance period is at least 12 months long and (3) for written plans in existence on December 31, 2004, employee elections for 2005 deferrals must be made **prior to March 15, 2005**.



Elections to re-defer compensation beyond originally-scheduled distribution date(s) are now specifically sanctioned, but only if: (1) the re-deferral election is made at least 12 months before the date of the first scheduled payment, and (2) the re-deferral period is at least 5 years, except for disability, death or unforeseeable emergency.

Beginning in 2005, any New Money deferred compensation may be distributed only if there is a "distributable event". Distributable events are limited to:

- separation from service (plus 6 months for certain key employees)
- disability (as defined in the Act and Regulations)
- death
- specified time or schedule fixed at the date of the deferral
- change in control (to the extent provided in Regulations)
- unforeseeable emergency (as defined in the Act)

Acceleration of distribution dates is not allowed.

Some deferred compensation plans provide for funding through the use of Rabbi Trusts. Rabbi Trusts continue to be sanctioned. However, off-shore Rabbi Trusts are no longer permitted.

Some existing non-qualified deferred compensation plans require funding if there is an adverse change in the employer's financial health. Financial health triggers will no longer be permitted – if the plan allows for them, deferral is not allowed.

Beginning in 2005, all amounts deferred must be currently reported on a Form W-2 (for employers) or Form 1099 (for independent contractors, such as directors), even if the amount is not currently includible in income for the year of deferral. This annual reporting may impact Social Security and State income taxes.

Amounts deferred and vested prior to 2005 ("Old Money") become subject to the new rules if there is a material modification to the existing non-qualified deferred compensation plan after October 3, 2004. In general, amending an old plan to comply with the new rules will not be treated as a "material modification."

All employers with existing non-qualified deferred compensation plans must determine if their existing plans comply with the new rules. If the existing plans do not comply, then a strategy must be developed to protect the Old Money by either freezing the plan at December 31, 2004 or amending it to comply with the new rules. For more information, call Gerry Rigby in our Philadelphia office at 215-568-4166.