LAW·FLASH
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Deferred Compensation Election Deadline – March 15, 2005; New Supplemental Withholding Rules for Compensation in Excess of $1 Million

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As noted in our prior LawFlashes, the recent Internal Revenue Service (IRS) guidance (Notice 2005-1) with respect to implementation of the new deferred compensation restrictions set forth in Section 409A of the Internal Revenue Code (added by the American Jobs Creation Act of 2004) provides the following:

- General Rule: Elections must be made in the calendar year prior to the year in which the services are to be performed, subject to (i) an exception permitting deferral elections during the 30-day period commencing with the date of first participation in a plan; and (ii) the six-month rule discussed below.

- Exception for 2005: Because the new general rule imposed by Section 409A was added to the law with relatively little advance notice late in 2004, the IRS guidance permits deferrals for periods including any portion of the 2005 calendar year to be made as late as March 15, 2005, so long as the compensation subject to the election is not already paid or payable (i.e., no "retroactive" deferrals are possible). Thus, 2005 bonus or base salary may be deferred by making a valid election by March 15, 2005, as can amounts payable with reference to fiscal year performance periods that include any portion of the 2005 calendar year (such as a fiscal year bonus plan including any portion of 2005).

  This election may be as simple as an election to defer a specified dollar amount or percentage of the relevant compensation, and need not specify the form and timing of distributions. The March 15 date represents an important opportunity to make deferral elections, and it should be assumed that the date will not be extended.

- Plan Revisions by December 31, 2005; Election Revocation/Modification Opportunity: The IRS guidance allows plan sponsors until December 31, 2005 to conform their plans to the requirements of Section 409A so long as the plans are operated in reasonable good faith conformity with the new requirements in the interim. As a result, elections as to timing and form of distribution need not be made until December 31, 2005. In addition, the IRS guidance would permit those participants making elections by March 15, 2005 to revoke or modify the elections by year end 2005, provided that the relevant plan permits such revocation or modification and the compensation subject to the revocation or modification is included in 2005 taxable income of the participant.

- Uncertain Scope of Six-Month Rule: The new rules permit a more relaxed timetable for elections to defer income resulting from performance-based plans. As a general matter, these elections will be valid if made not later than six months prior to the end of the performance period. Thus, for performance-based plans operating in 2005, this rule may provide a later election date than March 15 (e.g., June 30 for a calendar-year plan). The guidance provides that until further guidance is issued (which is expected to be more restrictive than the requirements set forth in the initial guidance), bonus compensation will meet the performance-based exception if the payment of the bonus is contingent on the satisfaction of organizational or individual performance criteria, and the performance criteria are not substantially certain to be met at the time the deferral election is permitted. Subjective criteria may be used, provided that the subjective criteria relate to the performance of the employee, a group of employees that includes the participant employee, or a business unit for which the employee provides services (which may include the employer as a whole). The determination of whether or not the criteria are met may not be made by the employee or a family member of the employee. The guidance does not require that performance criteria be approved by the employer's compensation committee, board of directors or stockholders. Bonus compensation that is paid regardless of performance, or on the basis of performance targets that are substantially certain to be met at the time the targets are established, or that is based solely on the rate of, or appreciation in value of, the employer or the employer's stock, will not constitute performance-based compensation that will meet the exception. Accordingly, if there is any uncertainty with respect to whether a plan will fall within the performance-based exception, it may be prudent to make deferral elections by March 15, 2005 with respect to such bonus compensation.

- Uncertain Status of "Excess Plan" Elections. A number of nonqualified deferred compensation plans operate in tandem with a qualified plan such that the participant's deferral amount to the nonqualified plan is determined with reference to events occurring under the qualified plan during the course of the year. For example, a participant may elect to defer under a qualified 401(k) plan the maximum amount permitted as an elective deferral under Section 402(g) ($14,000 for 2005), but subject to a provision in the related nonqualified plan to the effect that if any amount of the initially elected deferral is not permitted to be contributed to the qualified 401(k) plan under applicable nondiscrimination ADP tests, then the disallowed amount will be allocated to the participant's deferred compensation plan account. Similarly, some sponsors' arrangements provide that the full amount deferred is deemed contributed to the nonqualified plan and then amounts are transferred to the qualified 401(k) plan over time (sometimes referred to as a "pourover" or "spillover" plan). Under the new Section 409A rules, it could be argued that such a procedure (especially the "pourover/spillover" approach) violates the new requirements regarding timing of elections. While industry groups are requesting an extension of the March 15 election date for these "pourover/spillover" arrangements, it is not clear that the Department of the Treasury will respond favorably. As a result, plan sponsors should review these arrangements with counsel.

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New Supplemental Wage Withholding Rate Applies to Compensation in Excess of $1 Million. The American Jobs Creation Act contains a provision that the withholding rate applicable to compensation in excess of $1 million paid to an employee in a taxable year is to be 35% (the maximum individual tax rate) rather than the 25% rate previously applicable to supplemental wages. This new requirement will become effective in 2005, when recently issued IRS proposed regulations are finalized.

This new provision is problematic in a number of ways:

- The 35% rate applies only to the excess more than $1 million (“Excess Compensation”), and thus will require significant programming; the 25% rate will continue to apply to compensation that is not Excess Compensation.
- The use of this 35% rate on Excess Compensation is mandatory, and is not avoided even if the non-Excess Compensation is withheld upon using the regular (non-supplemental) rate.
- The 35% rate applies to compensatory amounts from all members of a controlled group; as a result, it may be necessary to coordinate the W-2 process for employees who receive compensatory payments from multiple members of the same group.

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