New Restrictions Apply to Nonqualified Deferred Compensation Plans

New York
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The Pension Protection Act of 2006 (the "Act"), which is expected to be signed into law by President Bush in the near future,[1] includes new restrictions on the funding of and reservation of assets under nonqualified deferred compensation plans that provide benefits for certain employees of public companies. These restrictions will apply if the company, or any another company that is in the same "controlled group," maintains a severely underfunded defined benefit pension plan in plan years after 2007 and will apply as soon as the Act becomes effective if the company or a controlled group member becomes bankrupt or if an underfunded plan sponsored by the company or a controlled group member is terminated. A controlled group generally consists of businesses connected through at least 80% common ownership.

Section 116 of the Act adds a new provision to Section 409A of the Internal Revenue Code of 1986, as amended (the "Code") under which certain amounts earmarked to pay deferred compensation of "covered employees" will be treated as deferred in violation of Section 409A (i.e., immediately included in income and subject to an additional 20% tax plus interest penalties) if either of the following applies:

1. A "restricted period" is in effect with respect to a defined benefit plan maintained by the company or a controlled group member. A restricted period means a period (a) during which a defined benefit plan is in "at-risk status" under the Act;[2] (b) during which the employer that sponsors a defined benefit plan is in bankruptcy; or (c)

[1] The Act was passed by the House of Representatives on July 28, 2006 and by the Senate on August 3, 2006.

[2] A plan is in at-risk status if it is less than 70% funded based on worst-case scenario assumptions (not counting credit balances and assuming that employees both retire at the earliest date on which they are eligible to retire and elect the richest benefits available to them) and less than 80% funded based on standard assumptions. Under a transition rule, instead of 80 percent, the following percentages apply: 65 % for 2008, 70 % for 2009, and 75% for 2010. At-risk status only applies with respect to plan years beginning after 2007.

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beginning six months before and ending six months after an involuntary or distress termination of any defined benefit plan maintained by the company or any controlled group member.

2. The nonqualified deferred compensation plan provides that assets will become restricted to the provision of benefits under the plan in connection with a restricted period (or other similar financial measure to be determined by regulation) with respect to the defined benefit plan, or assets are so restricted.

Any assets that are set aside or transferred to a trust to pay nonqualified deferred compensation plan benefits during a restricted period will be treated as having been transferred to the covered employees in violation of Section 409A. The provision does not apply to assets that are used to fund a nonqualified deferred compensation plan before a restricted period begins. However, if a nonqualified deferred compensation plan provides that assets will be restricted to providing benefits under the plan if the company becomes financially distressed, or if assets are so restricted, such assets may be treated as having been transferred in violation of Section 409A. As is the case for any amounts deferred in violation of Section 409A, these amounts will be included in the recipient's income for the year in which they are deemed to have been transferred and will be subject to an additional 20% tax and interest penalties. In addition, the failure of amounts deferred under the plan to comply with Section 409A may affect participants' deferred compensation under other plans that would be deemed to be deferred under a single plan pursuant to Section 409A and the regulations thereunder.

"Covered employees" are employees who are subject to Section 162(m) of the Code or the reporting requirements of Section 16(a) of the Securities Exchange Act of 1934, as amended – in general, senior executives and officers of public companies – or former employees who were covered employees at the time their employment with the company or controlled group member was terminated.

Section 116 also provides that if the employer pays the taxes on the compensation required to be included in income as a result of this provision or reimburses the employee for such taxes, such payment will also be included in income and subject to the 20% additional tax and interest penalties, and will not be deductible by the employer.

The amendments effected by Section 116 of the Act will apply to transfers or reservations of assets after the date on which the Act becomes law, which is expected to be within the next week to two weeks.

Employers should review any funding or other similar arrangements in light of these new rules to determine whether such arrangements should be modified to ensure that the penalties described above will not be triggered.

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Please do not hesitate to contact any of your regular contacts at the firm or any of the lawyers listed on the firm website under the "Employee Benefits" practice heading in connection with these matters.

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