

## MEMORANDUM

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TO: Tribal Clients

FROM: Robert A. Burns, Esq.  
Timothy D.S. Goodman, Esq.  
Dorsey & Whitney LLP

DATE: October 14, 2004

RE: New Deferred Compensation Legislation

Congress has passed the American Jobs Creation Act of 2004 (H.R. 4520) (the “Act”), which places significant restrictions on nonqualified deferred compensation arrangements,<sup>1</sup> and imposes immediate taxation and penalties for failing to comply. **The penalties include a 20% tax on the amount deferred in addition to regular income tax on that amount.** In general, the Act is effective January 1, 2005.

Given the severe penalties and the rapidly approaching effective date, Tribes and tribal entities should review their deferred compensation arrangements **now** and be prepared to modify agreements and plans to come into compliance with the Act before the end of this year.

### Scope

The Act’s definition of “deferred compensation” is very broad. It includes any plan, agreement, or arrangement that defers compensation. This includes agreements with individual employees that provide deferred compensation, such as employment agreements and severance agreements. It also includes bonuses earned in one year and paid after March 15 of the following year. And the Act applies whether the employer defers compensation for the employee or an employee elects to defer their own compensation.

### Tax Consequences and Penalties

The Act imposes tax consequences and penalties on deferred compensation that fails to meet the requirements of the newly created section 409A of the Internal Revenue Code, unless it is subject to a substantial risk of forfeiture. An employee whose deferred compensation fails to meet the requirements must immediately include the deferred compensation amount in gross income. In addition, the employee must pay:

- An additional tax of 20% on the amount of deferred compensation (plus earnings).
- An interest payment equal to the underpayment rate (currently 4%) plus 1% on the underpayments that have occurred because the compensation was not included in gross income when it was first deferred.

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<sup>1</sup> The Act does not apply to tax-qualified retirement plans such as 401(a) and 401(k) plans.

## Restrictions Imposed By New Section 409A of the Internal Revenue Code

*Elective Contributions.* The Act requires an employee's election to defer regular compensation such as wages to be made in the taxable year preceding the taxable year in which the employee performs the services that earn the compensation (with limited exceptions).

*Distributions.* The Act prohibits distributions before the following events:

- Separation from service (termination)
- Disability
- Death
- A future date specified at the time of deferral
- A change in ownership
- An unforeseeable emergency

*Acceleration of Distributions.* The Act prohibits accelerating the payment of distributions except as permitted under regulations to be issued by the Secretary of the Treasury.

*Delay of Distributions.* The Act restricts an employee's ability to make subsequent elections. In general, it requires elections to delay distribution to be made by an employee at least 12 months before the date the first payment was initially scheduled to be made. It generally also requires that the first payment be delayed for five years from the original payment date.

## Reporting of Deferred Compensation

The Act also requires an employer to report such deferred compensation on the employee's Form W-2 or 1099 in the taxable year in which the deferral occurs.

## 457 Plans

The Act raises special issues for Tribes and tribal entities that have adopted 457 plans that are difficult to summarize in this update. Tribes and tribal entities that have adopted 457 plans should consult with tax or benefits counsel about the impact of this new legislation.

## Effective Date

The Act is effective for all deferrals after December 31, 2004. If a Tribe or tribal entity materially modifies a deferred compensation agreement, arrangement, or plan before then to provide additional benefits or rights, then the new rules apply immediately.

## Conclusion

Tribes and tribal entities with employment agreements, severance agreements, or plans that provide deferred compensation should consult with tax or benefits counsel regarding the Act. If you have a question regarding the Act, please contact the attorney with whom you work or please call us at (612) 340-2825 (Tim Goodman) or (612) 340-8788 (Bob Burns).

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