

PRESIDENT SIGNS NEW LAW AFFECTING NONQUALIFIED DEFERRED COMPENSATION PLANS

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On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 (the “Act”). The Act makes significant changes to the rules governing nonqualified deferred compensation (“NQDC”) plans and will require that changes be made to such plans in the near future to ensure compliance therewith.

Effective Date

The new requirements are effective for amounts deferred in taxable years beginning before January 1, 2005. Amounts deferred prior to December 31, 2004 are subject to the new rules only to the extent that the plan under which they are deferred is “materially modified” after October 3, 2004. Earnings on amounts deferred are subject to the new rules only to the extent that the deferrals from which they derive are subject to the rules. The Act directs the IRS to issue, within 60 days of enactment, guidance providing, among other things, a limited transition period to bring existing plans into compliance with the new rules.

Plans Affected

The Act will impact many executive compensation plans as the definition of “nonqualified deferred compensation plan” under the Act is broad and includes such arrangements regardless of: the number of individuals covered, whether the arrangement is funded by the service-provider or the employer, whether the related services are rendered by an employee, a consultant or an independent contractor, or whether the plan is an account-based or a defined benefit plan.

Thus the new rules would impact the following compensation arrangements, among others:

- elective deferred compensation plans;
- non-elective deferred compensation arrangements such as supplemental executive retirement plans (“SERPS”);
- stock appreciation rights (“SARs”);
- possibly, equity-based grants analogous to SARs;
- stock options issued with an exercise price that is less than fair market value at grant; and
- director fee arrangements.

Other arrangements that should be examined to see whether they fall within the scope of or are otherwise affected by the new rules include:

- individual agreements, including employment and severance agreements;
- group-based incentive compensation programs with a potential tax-deferral element; and
- arrangements covering non-employee service providers.

Plans that are not affected by the Act include:

- bona fide vacation, sick leave, compensatory time, disability pay or death benefit plans;
- qualified retirement plans;
- annual bonus programs that pay-out within 2 1/2 months after year end;
- qualified stock options; and
- non-qualified stock options with an exercise price of at least fair market value at grant.

The New Rules

In order to comply with the new rules, an affected plan must comply with the following:

1. **Distribution Restrictions.** Benefit payment events must be limited to the following:
 - Separation From Service (note however that for key employees of public companies, distributions may not be made earlier than six months after separation from service);
 - Death;
 - Disability;
 - Unforeseen Financial Emergencies of the participant, the participant's spouse or the participant's income tax dependant;
 - At a specified time or pursuant to a fixed schedule specified under the plan at the date of deferral (note however that distribution upon a specified event, such as the participant's child attending college is not permitted); and
 - Change in Control of the employer - to the extent provided by the IRS.
2. **Prohibition on Acceleration.** The time or schedule (e.g., installment vs. lump sum) of payments may not be accelerated except as permitted by regulations.
 - Eliminates use of so-called "haircut" provisions under which benefits are reduced by a 10% penalty upon an election to accelerate payment;
 - Regulations can be expected to provide exceptions for events beyond a participant's control (e.g., due to federal conflict of interest rules or pursuant to a court-approved divorce settlement), for payroll tax withholdings taken from the participant's plan benefits, and for administrative convenience in certain circumstances.

3. **Timing of Participant Elections.**

- Deferral elections must be made prior to the year during which the services upon which the deferred compensation is based are performed.
- New participants may, however, elect within 30 days of first becoming eligible.
- An election to defer performance-based compensation may be made up to six months before the end of a performance period that lasts for at least 12 months.
- At the time of election the plan may allow a participant to choose from a variety of permitted payment events as well as a variety of payment forms.

4. **Changes in Time or Form of Distribution.**

- Subsequent elections to further delay the timing of distribution or to change the form of payment may be made but will not take effect for at least 12 months following the subsequent elections. In addition, the plan must provide that the payment commencement date under the subsequent election be at least five years later than such date under the prior election, except in the case of distributions on account of death, disability or unforeseeable emergency.

5. **Offshore Trusts.**

- If assets earmarked for the purpose of paying deferred compensation are set aside directly or indirectly in a trust located outside of the U.S. (whether initially placed abroad or initially placed domestically and later moved abroad), the assets are considered to be transferred to affected participants pursuant to the rules set forth in Code Section 83, and accordingly are subject to immediate taxation unless the participant's right to the property is subject to a substantial risk of forfeiture (i.e., conditioned upon the future performance of services).
- This rule does not apply where substantially all of the services to which the deferred compensation relates are performed in the jurisdiction in which the assets are located.

6. **Security Arrangements.**

- Any arrangement that provides that upon a change in the employer's financial health assets will be restricted to payment of NQDC benefits in connection with a change in the employer's financial health (whether or not the assets remain subject to the employer's creditors) will result in taxation under rules similar to those discussed above with respect to offshore trusts.

Consequences of Noncompliance

Failure to comply with the new requirements will result in onerous tax consequences. Specifically, affected participants will be subject to: (1) current inclusion in gross income of all vested compensation deferred in the current year and in all prior years (to the extent not previously included in income); (2) liability for interest at the tax underpayment rate plus one

percent accruing from the date the included amount was first deferred or vested; and (3) an additional tax equal to 20% of the amount included. Note that although the employer is in control of compliance with the new rules, it is the participants and not the employer that is subject to tax consequences for failure to comply. The practical effect of the tax consequences of noncompliance for an affected individual is to make it more costly to defer the tax on the affected item of income than it is to be currently taxed on such item.

Reporting Requirements

Employers must report all amounts deferred each year under a NQDC plan on the participant's W-2 or 1099, as applicable, and must withhold federal income taxes with respect to the amounts reported for current or former employees.

Suggested Actions

It is recommended that you begin planning for the changes required to ensure compliance with the Act. Accordingly, you should consider taking the following actions:

- Create an action plan in response to the Act, including the development of appropriate internal controls to ensure compliance.
- Identify and keep an inventory of the plans and the individuals affected by the Act.
- Evaluate the alternatives available for compliance with the Act and decide which is the best alternative(s) with respect to each affected plan. Consider the possibility of freezing existing plans and creating new plans that comply with the Act. Identify the actions required to make the changes necessitated by the Act with respect to each affected plan such as the procedures required for amendment
- To the extent possible, avoid making any plan amendments or granting any stock appreciation rights or similar forms of compensation until the IRS issues guidance with respect to the Act.
- Communicate the potential impact of the Act to affected individuals and continue to keep them updated as additional guidance becomes available.
- Brief the Compensation Committee and the Board of Directors on the new rules and the changes that will need to be made to affected plans.
- Monitor the publication of IRS guidance with respect to the Act.