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New Deferred Compensation Legislation – Summary and Action Steps

The House and Senate recently approved far-reaching changes in the federal tax laws that apply to nonqualified deferred compensation plans as part of the American Jobs Creation Act of 2004 (the "Act"). The President signed the Act into law on October 22, 2004 (Pub. L. No. 108-357).

The Act adds a new section 409A to the Internal Revenue Code ("Code") that applies to amounts "deferred" (generally, earned and vested) after 2004. For the first time, the Code provides specific rules for deferral elections, distributions, and certain funding mechanisms under nonqualified deferred compensation plans. We outline below the key portions of the Act and the accompanying conference report. The Act does not include controversial provisions relating to restrictions on investment control and the prohibition on deferrals of stock option gains and other equity compensation, which were included in the Senate version of the legislation (S. 1637, the "Jumpstart Our Business Strength" (JOBS) Act of 2004).

I. Summary

A. Definition of Nonqualified Deferred Compensation Plan

A "nonqualified deferred compensation plan" is defined in section 409A as any plan that provides for the deferral of compensation. In addition to plans that permit participants to elect to defer compensation, nonqualified defined benefit plans (i.e., "SERPs") are covered by the definition. Further, any plan, arrangement, or agreement, including those covering only one person, is covered. The conference report also makes clear that plans covering non-employees are covered by the new rules. Plans that are specifically excepted from the definition are limited to:

- tax-qualified plans, tax-deferred annuities, 457(b) plans, SEPs, SIMPLEs, and qualified governmental excess benefit arrangements under section 415(m), and

- any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

According to the conference report, the new rules will not apply to annual bonuses or other annual compensation amounts paid within 2½ months after the close of the year in which the relevant services required for payment have been performed. Absent favorable IRS guidance, severance plans would appear to be subject to the new rules.

B. Equity Compensation Plans

Many common equity compensation arrangements could be said to involve a deferral of compensation and thus be subject to the new rules. Fortunately, the conference report provides that fair market value nonqualified stock options, incentive stock options, and employee stock purchase plans are not subject to the new legislation. It appears that stock appreciation rights ("SARs") are covered by the legislation, but the conference report states that the IRS may address issues related to SARs in regulations. Restricted stock and restricted stock units are not addressed in the Act or the report, so their status may be determined by IRS regulations.

C. Initial Deferral Elections

Section 409A requires initial participant elections to defer compensation to be made before the beginning of the taxable year in which the services are performed giving rise to the compensation, or at such other time as provided in regulations. An exception to this general rule provides a 30-day election period for newly eligible participants. Another important exception is for "performance-based compensation" earned over a period of at least twelve months. Under section 409A, an initial election to defer such compensation may be made as late as six months prior to the end of such period. As noted below, constructive receipt rules under Code section 451 would still apply to such an election, and could impose additional limitations.

The conference report states that it is intended that the IRS will define "performance-based compensation" to include an amount to the extent it is: (1) variable and contingent on the satisfaction of pre-established organizational or individual performance criteria, and (2) not readily ascertainable at the time of the election. Further, the report provides that performance-based compensation may need to meet certain requirements similar to those under Code section 162(m), but would not be required to meet all requirements under that section. For example, the report states that it is expected that the IRS will provide that performance criteria would be considered pre-established if established in writing no later than 90 days after the commencement of the service

period, but the section 162(m) requirement that the company's compensation committee determine the criteria would not be required.

A bonus based on objective criteria established in writing on a timely basis will likely be considered "performance-based compensation." Thus, if a participant is entitled to a bonus payable in 2007 based on the employer achieving a certain level of earnings per share for 2006, the participant may be able to make an election as late as June 30, 2006 to defer payment of the bonus.

D. Distributions

The time and form of distribution for a deferred amount must be specified either in the plan or by the participant at the time of deferral. Deferred amounts may be distributed only upon:

- separation from service (as determined by IRS),
- death,
- disability,
- a specified time or pursuant to a fixed schedule (which may be elected by the participant at the time of deferral),
- a change in ownership or effective control of the employer, or in the ownership of a substantial portion of the assets of the employer, to the extent provided in IRS regulations (under similar, but more restrictive, standards to the golden parachute rules in Code section 280G), and
- an unforeseeable emergency (under standards similar to the unforeseeable emergency requirements in the final Code section 457 regulations).

A participant will be considered disabled for this purpose if either (1) the participant is disabled within the meaning of the Social Security Act, or (2) the participant is receiving income replacement benefits for a period of at least three months under an accident and health plan of the employer, by reason of a medically determinable physical or mental impairment which can be expected to result in death or last for a continuous period of at least 12 months. Payments to "key employees" (as defined under the Code section 416(i) top heavy rules, which would include up to 50 officers) of a publicly traded corporation may not be made in the first six months following the individual's separation from service.

E. Acceleration Generally Prohibited

The acceleration of payments before the time or schedule specified at the time of deferral is prohibited, except as provided by IRS regulations. This rule would eliminate the use of so-called "haircut" provisions. Also, changes in the form of payment that would result in an acceleration of payments (e.g., from an annuity to a lump sum) would not be permitted.

The conference report indicates that a choice between cash and taxable property will not violate the prohibition if the timing and amount of income inclusion is the same regardless of the medium of distribution. For example, the choice between a fully taxable annuity contract and a lump sum payment may be permitted. The conference report also states that it is intended the IRS will provide:

- rules under which the choice between different forms of actuarially equivalent life annuity payments is permitted,
- other limited exceptions, such as when an accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective, e.g., to comply with a court-approved divorce settlement,
- that a plan would not violate the prohibition by providing that withholding of an employee's share of employment taxes will be made from the employee's interest in the plan,
- that a plan would not violate the prohibition by making a distribution to a participant to pay income taxes upon a section 457(f) vesting event, and
- that a plan would not violate the prohibition by providing for automatic distributions of minimal account balances upon permissible distribution events for purposes of administrative convenience, e.g., automatic cashout of account balances less than \$10,000.

F. Subsequent Deferral Elections

Any subsequent election to delay the timing or change the form of payment generally must (1) not take effect until at least 12 months after the date of the election, (2) provide an additional deferral for a period of at least five years from the date such payment would otherwise have been made, except in the case of elections relating to distributions on death, disability, or unforeseeable emergency, and (3) if related to a payment at a specified time or pursuant to a fixed schedule, be made at least 12 months

prior to the date of the first scheduled payment. The conference report states that the IRS may also issue regulations in this area regarding elections with respect to payments under nonelective plans, e.g., SERPs.

G. Effect of Violations

If the deferral election or distribution requirements of section 409A are violated as to a participant, all amounts deferred for the participant under a plan (including earnings) for all taxable years are taxed immediately, except to the extent the amounts are subject to a substantial risk of forfeiture. Interest at the underpayment rate plus one percent is imposed on the underpayments that would have occurred had the compensation been taxable when first deferred or, if later, when not subject to a substantial risk of forfeiture. A twenty-percent additional tax is also imposed upon the amount of compensation which is required to be included in a participant's gross income.

Unlike provisions in earlier versions of the legislation, a violation will only result in taxation for the participants with respect to whom the violation relates. For example, if two plan participants improperly receive distributions before one of the specified events listed above, no other participants will be affected by the violation. However, if a plan document contains a provision that violates the requirements, all plan participants could be subject to immediate taxation. A footnote in the conference report indicates that a violation of the new rules will only cause adverse tax results for the portion of a plan subject to the new rules (generally the post-2004 deferrals).

H. Offshore Rabbi Trusts

Assets set aside (directly or indirectly) in an offshore trust for the purposes of paying nonqualified deferred compensation are treated as property transferred under Code section 83 at the time set aside or transferred outside the U.S., whether or not the assets are available to satisfy claims of general creditors. Earnings on such assets are treated as additional transfers of property. Thus, participants would be immediately taxed on deferred amounts when they are no longer subject to a substantial risk of forfeiture. Interest and the twenty-percent additional tax as described above would also apply.

This rule does not apply to assets located in a foreign jurisdiction if the deferred compensation relates to services performed in such offshore jurisdiction, and the IRS is granted regulatory authority to provide exceptions for arrangements that will not result in the improper deferral of U.S. tax and where assets will not be effectively beyond the reach of creditors.

I. Financial Distress Triggers

A transfer of property occurs under Code section 83 with respect to deferred compensation if a plan provides that, upon a change in the employer's financial health, assets will be restricted to the provision of plan benefits. Surprisingly, section 409A provides that such a transfer occurs even if the "restricted" assets are subject to the claims of creditors. Thus, the conference report states that a transfer to a rabbi trust (where amounts remain subject to the claims of creditors) upon a change in the employer's financial health will implicate this provision. Fortunately, the report goes on to state that the provision is not intended to apply when assets are restricted for a reason other than a change in financial health (e.g., upon a change in control) or if assets are periodically restricted under a structured schedule and scheduled restrictions happen to coincide with a change in financial status.

Earnings on restricted assets are treated as additional transfers of property. Thus, participants would be immediately taxed on deferred amounts when they are no longer subject to a substantial risk of forfeiture. Interest and the additional twenty-percent tax as described above would also apply. The IRS is granted regulatory authority to provide exceptions for arrangements that will not result in the improper deferral of U.S. tax and where assets will not be effectively beyond the reach of creditors.

J. Effect of Other Code Sections

Section 409A makes clear that another section of the Code may require a deferred amount to be includible in income earlier than required under section 409A. For example, section 451 (constructive receipt rules) or section 83 (compensatory transfers of property) may require inclusion before section 409A. However, once an amount is included under section 409A, it will not be includible under any such other section.

K. Effective Date

Section 409A applies to "amounts deferred" after 2004. The Section applies to earnings on deferred amounts only to the extent that such deferred amounts are subject to the Section. The conference report states that for purposes of the effective date, an amount is considered deferred before 2005, if the amount is earned and vested before such date.

Amounts deferred under a plan before 2005, are subject to the new rules only if the plan is "materially modified" after October 3, 2004. The statute provides that a plan may be amended in accordance with IRS guidance to add the new rules for post-2004 deferrals without jeopardizing the grandfathered status of pre-2005 deferrals under the plan. The conference report provides guidance on whether other modifications may

subject pre-2005 deferrals to the new rules. Specifically, the report states that the addition of any benefit, right, or feature is a material modification, while the exercise or reduction of an existing benefit, right, or feature is not. The report analyzes several examples of modifications as follows:

- an amendment to add a provision that distributions may be allowed upon request if participants are required to forfeit 10 percent of the amount of the distribution (i.e., a "haircut") is a material modification,
- accelerating vesting under a plan is a material modification,
- a change in the plan administrator is not a material modification,
- amending a plan to remove a distribution provision (e.g., to remove a "haircut") is not a material modification.

The report also makes clear that a subsequent deferral election may be made with respect to an amount originally deferred prior to 2005 without subjecting the amount to the new rules.

L. Transition Relief

The IRS is directed to issue guidance within 60 days of enactment permitting a limited period of time during which deferred compensation plans adopted before December 31, 2004, may be amended to (1) permit participants to terminate participation or cancel an outstanding deferral election with regard to amounts deferred after December 31, 2004, provided that those amounts are includible in income as earned (or if later, when no longer subject to a substantial risk of forfeiture), and (2) conform with the requirements of section 409A for amounts deferred after December 31, 2004.

The conference report provides that it is expected the IRS may provide exceptions to certain requirements during the transition period (e.g., the rules regarding timing of elections) for plans coming into compliance with the new rules. Further, the report states that it is expected that the IRS will provide a reasonable time, during the transition period but after the issuance of guidance, for plans to be amended and approved by the appropriate parties.

M. Reporting and Withholding

Amounts deferred under a nonqualified deferred compensation plan would be required to be reported to the IRS on an individual's Form W-2 (or Form 1099-MISC for non-employees) for the year deferred. IRS is granted regulatory authority to establish a

minimum amount of deferrals under which the Form W-2 reporting would not be required. The conference report also states that the IRS may provide for later reporting of amounts deferred under a nonaccount balance plan (e.g., a SERP) which are not "reasonably ascertainable."

Amounts required to be included in income under section 409A will need to be reported on a Form W-2 (or Form 1099-MISC for non-employees) for the year included, and includible amounts for employees will be subject to Federal income tax withholding.

N. Direction to IRS

The IRS is directed to issue regulations to carry out the purposes of these new rules, including regulations relating to the treatment of nonqualified defined benefit plans, changes in control of a corporation, the standard for determining a change in an employer's "financial health," and disregarding a substantial risk of forfeiture where necessary to carry out the purposes of the legislation.

II. Action Steps

As explained above, the deferred compensation changes apply to amounts "deferred" (generally, earned and vested) after 2004, so employers need to quickly begin assessing the legislation's impact on their executive compensation arrangements. We describe below 10 important steps that employers will need to take soon.

1. Become Familiar With the Act – Employers that have not already done so will need to quickly understand the key terms of the Act. This summary should serve as a useful starting point.

2. Identify Affected Plans – In addition to typical elective deferral plans and defined benefit plans ("SERPs"), the Act affects certain types of equity compensation plans and other arrangements that have not generally been considered deferred compensation plans. An employer will need to identify its plans and arrangements that could be impacted.

3. Determine Necessary Changes to Retirement Plans – An employer will need to determine the changes to its existing retirement plans that the legislation would require. The following changes would need to be made to many plans:

- "Haircut" in-service withdrawal provisions will need to be removed.
- Elections as to timing and form of payment that are tied to elections under a qualified plan (often found in SERPs) may need to be revised.

- Elections to defer "performance-based compensation" will need to be made at least six months before the end of the relevant performance period.
- Subsequent elections to defer payment of a distribution upon certain events will need to provide for an additional deferral period of at least five years from the date the payment would have otherwise been made.
- The ability of a participant to change the scheduled form of payment for a deferred amount from installments to a lump sum will need to be removed.
- Payments to "key employees" of a public company upon separation from service will need to be delayed for six months.
- The definition of "disability" may need to be revised.

4. Consider Impact on Equity Compensation Awards – In addition to the impact on retirement plans, an employer will need to consider the impact of the Act on its equity compensation practices. It appears that traditional stock options will not be subject to the new rules, while certain other forms of equity awards, such as stock appreciation rights, will be. A prohibition on deferral of equity awards was not included in the Act, but the treatment of any such deferrals under the new rules will need to be carefully analyzed.

5. Consider Amending Existing Plans v. Establishing New Plans – The Act provides that an amount deferred under a plan prior to 2005 will not be subject to the new rules unless the plan is "materially modified" after October 3, 2004. Amending a plan in accordance with IRS guidance to add the new rules for post-2004 deferrals should not jeopardize the grandfathered status of pre-2005 deferrals under the plan. Thus, a plan may be amended to essentially split the plan in two – the pre-2005 portion which would be subject to existing law, and the post-2004 portion subject to the new rules. A footnote in the conference report indicates that a violation of the new rules will only cause adverse tax results for the portion of the plan subject to the new rules.

Although it may only be a difference in form, an employer may instead choose to freeze an existing plan as of the end of 2004, and create a new plan that will apply to amounts deferred after 2004 and comply with the legislation. Either way, there will be administrative burdens and employee communication challenges.

The legislation directs the IRS to issue guidance within 60 days of enactment providing a limited period of time during which an employer may amend a plan to conform with the legislation. We understand from Treasury Department officials that plan documents will likely not actually need to be amended until some time in 2005, and

that within this 60-day period they will also likely provide transition relief for deferral elections.

Because deferred compensation plans are typically exempt from most substantive requirements of ERISA, they are analyzed as contracts between the employer and plan participants. Thus, an employer should consider contractual restraints on its ability to amend an existing plan (e.g., to remove distribution rights), particularly with respect to amounts already deferred.

6. Arrange Appropriate Approvals – Whether existing plans are to be amended or new plans established, the employer's Board of Directors (or a committee with appropriate authorization) will likely need to approve the new structure in a timely manner. An employer may want to schedule a meeting of the appropriate body close to year-end for this purpose, so that as much IRS guidance as possible can be considered prior to the approval of the new structure.

7. Securities Law Issues for Public Companies – The establishment or material amendment of a deferred compensation plan by a public company will generally need to be reported to the SEC on a Form 8-K within four business days. The new plan or amendment will typically need to be included with the next Form 10-Q or Form 10-K filed by the company. The NYSE and NASDAQ corporate governance rules and shareholder approval requirements (for plans that provide for the distribution of employer securities to participants) should also be considered.

If a new plan allowing for elective deferrals is to be created, the need to register the plan with the SEC on a Form S-8 and distribute a prospectus on the plan to eligible employees should be analyzed. If elective deferrals will continue under a plan the employer has already registered with the SEC, the plan prospectus should be updated for any changes to the plan and to reflect the newly applicable tax rules.

8. Revise Election Forms and Employee Communications – Deferral election forms and other materials that are to be provided to employees at the end of 2004 should be revised to reflect any changes made to a plan. An employer should attempt to delay the delivery of revised forms and other materials until the IRS transition relief mentioned above is issued. One key area that could be impacted by the transition relief is elections to defer bonuses based on 2004 performance.

9. Amend Plan Documents – As noted above, an employer's Board of Directors (or a committee) will likely need to approve plan changes by the end of 2004. However, the IRS will likely permit employers to delay amending plan documents to

bring them into compliance with the new rules for post-2004 deferrals until some date in 2005.

10. Revise Service Provider Agreements – An employer may need to revise service provider agreements (e.g., rabbi trust or recordkeeping agreements) if new plans are created or existing plans are amended.

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Please call us with questions about the new law, including its impact on your executive compensation arrangements.