

AMERICAN JOBS CREATION ACT: HOW IT AFFECTS DEFERRED COMPENSATION

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Background

- Popular press reporting on non-qualified deferred compensation (e.g., New York Times series).
- Joint Committee report on Enron.
- Growing perception in Congress (even among Republicans) that non-qualified deferred compensation plans are subject to abuse.
- American Jobs Creation Act of 2004 was approved by the Senate on October 11, 2004 (following approval by the House of Representatives on October 7) and signed by the President on October 22, 2004.

New Code Section 409A: General Rule

- Deferred compensation results in current taxable income as of the date the income is fully earned and not subject to a substantial risk of forfeiture unless the Act's new rules are met:
 - Timing of elections to defer income
 - Limited set of distribution events available
 - "Second elections" limited
 - No offshore funding

New Code Section 409A: General Rule (Continued)

- “Defective” deferrals subject the individual employee to taxation with a 20% penalty.
 - Defective deferral generally does not disqualify the plan; penalty is on the individual.
 - No “penalty” on employer.
- New rules generally effective for post 12/31/04 deferrals (but currently effective for unvested grants).

What is “Deferred Compensation”?

- “Any plan that provides for deferred compensation”
- Except excluded arrangements
- Individual (one-off) arrangements are included
- Arrangements with non-employees (e.g., consultants) are included
- Both elective and non-elective arrangements are included

Plans Potentially Subject to the New Rules

- Nonqualified deferral plans
- 401(k) “wrap” plans
- Supplemental executive retirement plans (SERP)
- Excess benefit plans
- Employment agreements with deferral feature
- Tax-exempt and governmental plans --
Section 457(f)
- Severance plans and agreements
- Multi-year bonus deferral arrangements

Plans Potentially Subject to the New Rules (Continued)

- Stock appreciation rights (SARs)
- Restricted stock units (RSU)
- Phantom stock plans
- Option gain deferral arrangements
- Discounted options
- Non-qualified employee stock purchase plans
- Anything that “smells” like a deferral

Excluded Plans

- Qualified plans -- including 457(b) plans
- Incentive stock options
- Qualified employee stock purchase plans (423 plans)
- Vacation, sick leave, compensatory time, disability pay and death benefit
- Arrangements subject to Section 83:
restricted stock
- Bonuses paid within 2-1/2 months after end of tax year

Deferral Elections

- Permissible Deferral Elections
 - Election to defer must be made not later than the close of the tax year before the compensation is earned, with two exceptions.
 - Deferral election can be made within 30 days of date on which employee first becomes eligible to participate, with respect to compensation earned after election is made.

Deferral Elections (Continued)

- If the eligible compensation is “performance-based” and earned over a period of at least 12 months (i.e., annual bonus or long-term incentive compensation), the participant has until six months before the end of the performance period to make the election.
 - Similar to Section 162(m) -- performance-based compensation
 - Pre-established performance goals
 - Individual performance is permissible factor

Distributions

- Distributions may not be made earlier than:
 - Separation from service
 - 6 months after separation from service for key employees of public companies
 - Disability
 - Death
 - Specified time
 - Change of control -- as defined by IRS
 - Unforeseeable financial emergency -- narrowly defined

Distributions (Continued)

- Election for distribution at a specific time (or pursuant to a fixed schedule) must be specified under the plan as of the date of deferral.
 - Not upon occurrence of specific event (e.g., when child attends college).
- Key employee of a public company is:
 - An officer having annual compensation greater than \$135,000 for 2005 (up to 50 employees)
 - Employee who is a 5% owner
 - Employee who is a 1% owner and has annual compensation greater than \$150,000

Distributions (Continued)

- “Earlier of” distributions should be permissible -- e.g., earlier of separation from service or age 62.
- Payout on plan termination is not permitted.
- Separation from service -- “same desk rule” versus termination of employment.

Distributions (Continued)

- Second Elections
 - Election to delay distribution date or form of distribution is permitted only if:
 - Election cannot be effective for at least 12 months after the date of the election.
 - An election related to a deferral to a specified time must be made at least 12 months in advance of the scheduled distribution.

Distributions (Continued)

- The additional deferral must be for at least 5 years (except for elections relating to death, disability or emergency).
- Legislation does not seem to prohibit multiple “second elections”
- No acceleration

Distributions (Continued)

- Accelerations
 - No acceleration of the time or schedule for making payments is permitted.
 - This will preclude elections by participants to receive distributions subject to a penalty (“hair-cut” distributions).
 - The Act allows IRS to issue regulations permitting acceleration in certain cases.

Miscellaneous

- What's Missing?
 - The Act does not impose restrictions on the types of investments available to non-qualified plan participants.
 - The Act does not prohibit deferral of stock option gains, but option gain deferrals must meet the new rules.

Miscellaneous (Continued)

- Rabbi Trusts
 - Amounts set aside in off-shore rabbi trusts (and earnings) will be currently taxable.
 - Assets will be currently taxable if trust or plan provides that assets will be restricted to payment of benefits upon a change in employer's financial health.

Miscellaneous (Continued)

- IRS is authorized to issue regulations to address abuses of constructive receipt rules.
- IRS is authorized to issue rules relating to substantial risks of forfeiture.
- Deferred compensation will need to be reported on Form W-2 (even if not currently taxable).

Effective Date

- Effective Date
 - Amounts deferred in taxable years beginning after December 31, 2004.
 - Amounts (and earnings) deferred before January 1, 2005 are grandfathered.
 - Only amounts that are “earned and vested” as of December 31, 2004 are grandfathered.
 - Unvested rights (even if granted before 1/1/05) are subject to the new rules.

Effective Date (Continued)

- New rules apply to amounts deferred before January 1, 2005 under arrangements that are “materially modified” after October 3, 2004.
 - Takeaways are not “material modifications”
 - Elimination of haircut
 - Addition of a “benefit, right or feature” is likely to be a material modification.
- Cannot vest grants to obtain grandfather status
- “No inference” regarding compliance of existing arrangements with pre-Section 409A law.

Effective Date (Continued)

- Treasury Guidance
 - Treasury is to provide guidance by regulations allowing, for a limited period, the modification of deferred compensation plans:
 - To permit plan participants to terminate participation or to cancel outstanding deferral elections, or
 - To conform to the new rules.
 - Treasury is to issue the guidance within 60 days after enactment.

Effective Date (Continued)

- Special Situations
 - Unvested SARs/Discount Options
 - Grandfathered SERPs
 - Calculation of 12/31/04 accruals
 - Recordkeeping issues
 - Non-Grandfathered Existing Deferrals
 - Power to unilaterally amend may not exist
 - Deferral of 2004 Bonuses
 - Are they grandfathered

Big-Picture Issues

- Going Forward
 - Elections must be made up front unless performance-based compensation.
 - No discretion in employer or employee.
 - No haircut distributions.
 - Delay distributions to terminated key employees of public companies until 6 months after termination.
 - No accelerations upon change in employer's financial health.
 - No offshore trusts.
 - Use lump sum as default distribution.

What Should You Do Now?

- Inventory existing plans and identify the features in those plans that will not comply with the new rules.
- Consider which plans could be covered under the new rules.

What Should You Do Now?

- For elective salary and bonus deferral plans, consider the following:
 - Communicate the changes to participants when sending deferral elections.
 - Reserve the right to make changes in the deferral elections and the plan to comply with applicable law.
 - Make elections now for 2004 bonuses.
 - Make elections now for 2005 salary and bonuses, and for multi-year performance periods.

What Should You Do Now? (Continued)

- Consider whether deferral elections in 2004 should be made in the existing plans or in “mirror” plans that comply with the new rules.
- Consider the form and timing of distribution of new deferrals, since participants’ ability to make changes will be limited.
- Transition relief by the IRS is expected to allow plan participants to elect to conform to the new rules or to take their deferrals and pay tax if they do not wish to comply with the new rules.

What Should You Do Now? (Continued)

- Probably best to take no action now with respect to SERPs and non-elective plans.
- Important to avoid any material modifications of grandfathered plans.
- Consider having the Board of Directors delegate authority to one or more officers to make changes to deferred compensation plans, in case quick action is needed.
- Stay tuned for the regulations and be prepared to act quickly.

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