



New Federal Legislation Will Require Review of Deferred Compensation Plans

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The nonqualified deferred compensation legislation that has been under consideration in Congress sporadically for several years is now a reality, pending the President's expected signature. Generally effective as of January 1, 2005, the new legislation will result in sweeping changes to the taxation of nonqualified deferred compensation. Key elements of the new legislation, which will be found in a new Internal Revenue Code (Code) section 409A, are as follows:

- **Definition of Nonqualified Deferred Compensation** The legislation's broad definition of nonqualified deferred compensation includes any plan, agreement or arrangement that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. Qualified plans that are exempted from the definition include qualified retirement plans, 403(b) plans, eligible 457(b) plans (but not ineligible plans under section 457(f)), 415 (excess) plans, SEPs and SIMPLEs. The legislation is not limited to elective arrangements (e.g., it applies to defined benefit SERPs), nor is it limited to arrangements between employers and employees. It can also reach an agreement that covers just one person. In addition, the new law appears to apply to stock options and equity arrangements issued at a discount to fair market value on the date of grant, stock appreciation rights, phantom stock, restricted or deferred stock units and, under some circumstances, even to severance pay plans.
- **Timing of Elections**
 - ◆ **Initial Elections** Unless Treasury regulations take a more flexible approach, initial elections to defer compensation must be made prior to the taxable year in which the services are performed and must specify the time and form of distribution. This change represents a dramatic departure from current practice under almost all existing deferred compensation plans. A plan may itself specify the mandatory time and form of payments or allow the participant to elect the time and form of payment, subject to the limitations on forms of distributions discussed below. There are two exceptions to the initial election provision: (i) the legislation allows a 30-day grace period for elections made by newly eligible participants in a deferred compensation plan; and (ii) deferral elections with respect to "performance-based compensation" where the performance period is 12 months or more can be made up to six months prior to the end of the

performance period. Generally, “performance-based compensation” refers to an amount that is “variable and contingent on the satisfaction of pre-established organizational or individual performance criteria,” and “not readily ascertainable” at the time of the election, which seems to be comparable to (though perhaps less strict than) the standards under section 162(m) of the Code.

- ◆ **Subsequent elections.** A subsequent election to delay the timing or form of distributions is allowed only if (i) the subsequent election is not effective for at least 12 months, (ii) except with respect to distributions because of death, disability or an unforeseen emergency, the subsequent election defers distributions for not less than five years from the date the first payment would otherwise be made, and (iii) a subsequent election relating to a specified time may not be made less than 12 months before the date of the first originally scheduled payment.

➤ **Distributions** The new legislation requires that compensation deferred under a plan may be distributed only upon six specified events. These are:

- ◆ a separation from service,
- ◆ the death of the participant,
- ◆ the disability of the participant,
- ◆ a specified time (or fixed schedule) specified under the plan or elected by the participant at the date of the deferral (this must be a date and cannot be a specified event),
- ◆ a change in ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation, and
- ◆ the occurrence of an unforeseen emergency (generally a severe financial hardship as defined in Code section 457).

Key employees (as determined under Code section 416) of a publicly traded corporation may not receive a distribution for at least six months following a separation from service.

The legislation specifically prohibits distributions based on a haircut provision or a trigger caused by the company’s failing financial health.

➤ **Acceleration of Payments** A plan may no longer permit the acceleration of the time or schedule of any payment under a plan except as permitted by IRS regulations, subject to the following exceptions:

- ◆ distributions because of circumstances beyond the participant’s control (e.g., in order to comply with federal conflict of interest or court orders pursuant to a divorce),
- ◆ withholding of employment taxes,
- ◆ distributions necessary to pay income taxes due to vesting of a section 457(f) plan,

and

- ◆ distributions of minimal amounts for “administrative convenience.”
- **Effective Date** The legislation will be effective for deferrals made after December 31, 2004. Deferrals made prior to that date will generally be grandfathered, provided no material modifications have been made to the plan after October 3, 2004. For this purpose, existing deferrals are only grandfathered if the compensation was both earned and vested prior to the December 31, 2004 date; any attempt to vest currently unvested grants will likely be deemed a modification (see below).
- **Material Modification** A material modification is one that adds any benefit, right, or feature. For example, adding a haircut provision or accelerating vesting after October 3, 2004 would be a material modification. Note, however, that removing a provision permitting a distribution would not be a material modification.
- **Effect of a Violation** If a plan fails to meet all of the requirements of the new section 409A or is not operated in accordance with these requirements, all deferred amounts will be includable in the participant’s current gross income to the extent the compensation is no longer subject to a substantial risk of forfeiture. In addition, the participant will be subject to interest at the IRS underpayment rate plus one percentage point on all amounts that would have been included in income. An additional 20% tax will also be imposed the amounts required to be included in income. This set of “penalties” applies on a participant by participant basis; non-compliance as to one participant does not necessarily result in imposition of the “penalty” on another participant, nor does it disqualify the plan as a whole.
- **Treasury Guidance.** Treasury is obligated under the legislation to issue guidance within 60 days of the date of enactment that will:
 - ◆ permit a participant who elects a deferral subject to the new rules to cancel the deferral and be currently taxed, and
 - ◆ permit the terms of certain kinds of non-conforming elections made in 2004 to be modified to conform to the new rules.

In addition, Treasury will need to issue a broad array of interpretive guidance as to the new legislation, because Congress deferred to Treasury in large part with respect to specific articulation of the concepts set forth in the statute.

FAQs

Q: This seems like quite a lot of new requirements-what should I do now?

A: As a general rule, we would suggest that you continue with business as usual, pending issuance of guidance from Treasury and the IRS. The bill is effective immediately and there is no action available that will cause additional grandfathering. In fact, precipitous action, such as a plan amendment, may result in a material modification and loss of grandfathered status.

- Q:** Are all deferrals elected prior to January 1, 2005 grandfathered?
- A:** No, only those deferrals that are “earned and vested” are grandfathered. Accelerating vesting of deferrals after October 3 will be deemed a modification.
- Q:** If the deferral is grandfathered, does that mean it can continue to be subject to non-conforming election and distribution provisions (i.e., the “old” plan provisions)? Does the grandfather apply to earnings?
- A:** Yes, so long as the deferral is not materially modified.
- Q:** Does the new legislation override state contract law?
- A:** No, so there could be issues raised by a unilateral change to plan provisions if the plan does not permit such a change.
- Q:** Should we freeze our existing plans and establish new plans?
- A:** In many cases, there may not be a compelling reason to implement this strategy. However, there may be limited circumstances in which this approach will be advantageous. It certainly seems clear that the “new” plan would not be eligible for the 30-day deferral election.
- Q:** Does the enactment of this legislation mean that IRS will not audit pre-effective date years for deferred compensation practices that are now precluded?
- A:** No, the legislation expressly contemplates ongoing audit review of the pre-effective date practices.

What Should Be Done Now?

The legislation will necessarily involve significant changes to most existing deferred compensation plans, but we would suggest waiting until Treasury issues guidance to make changes. Plan sponsors should begin the process of determining which of their plans contain non-conforming provisions, and should alert plan participants making elections as to 2005 deferrals that the new rules will apply. We would recommend that you discuss your plan and your current circumstances with your Morgan Lewis lawyer to ascertain whether any action should be taken now.

Morgan Lewis’ Employee Benefits/Executive Compensation team has significant experience working with executive compensation issues. If you have questions or concerns, please contact the Morgan Lewis lawyer with whom you regularly work or any of the following:

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