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Legislation Contains Significant Deferred Compensation Changes

As recently passed by Congress, the American Jobs Creation Act of 2004 (the Act), H.R. 4520,[1] contains provisions that will significantly affect the operation of nonqualified deferred compensation plans by limiting the flexibility currently available for participants to alter the form and timing of the distribution of their benefits, as well as timing of deferral elections and funding mechanisms. Companies should be aware of the potential impact of this legislation on their nonqualified deferred compensation plans and equity compensation plans. Most nonqualified deferred compensation plans will need to be amended to comply with the new requirements. Additionally, deferral procedures may need to be modified prior to 2005.

"A complete review of nonqualified deferred compensation plans as well as deferral election procedures . . . should be undertaken prior to year-end 2004[.]"

Deferred Compensation Provisions

The deferred compensation provisions of the Act modify current law by subjecting vested deferred compensation to income tax unless deferral, election and non-acceleration requirements are satisfied. In addition, the Act broadly defines a nonqualified deferred compensation plan as any plan[2] that provides for the deferral of compensation other than a qualified employer plan or a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan.[3] It is unclear how the new legislation will impact certain forms of equity compensation, including stock appreciation rights, restricted stock units and grants of in-the-money stock options, which may be treated as forms of deferred compensation subject to taxation at vesting. Forthcoming Treasury regulations may provide guidance with respect to these matters.

The Act amends Section 409 of the Internal Revenue Code by adding new Section 409A which provides that vested[4] deferred compensation will be taxed on a current basis unless the grant meets certain requirements. In addition to immediate taxation on vested deferred compensation, participants will be required to pay a 20 percent additional income tax and, potentially, interest at the IRS underpayment rate plus one percent.[5] To avoid this treatment under the Act, a nonqualified deferred compensation plan must meet the following key requirements.

Distributions

The nonqualified deferred compensation plan may not distribute deferred compensation at any time before the occurrence of one of the following events:

- a *time (or times) specified* under the deferred compensation plan at the date of the deferral of such compensation;

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- the *participant's separation from service* (as provided by Treasury regulations); provided, however, that a nonqualified deferred compensation plan of a publicly traded company may not make a distribution to a "key employee"[6] until at least six months after his or her separation from service;
- the *participant's death*;
- the *participant's disability*; a participant is considered disabled if, due to any medically determinable physical or mental impairment expected to result in death or to last for a continuous period of at least 12 months, the participant is either unable to engage in any substantial gainful activity or is receiving income replacement benefits for a period of at least three months under the employer's accident and health plan;
- a *change in ownership or effective control* of the corporation or *in ownership of a substantial portion of the assets* of the corporation to the extent provided in Treasury regulations; or
- an *unforeseeable emergency*, defined as a severe financial hardship to the participant resulting from an illness or accident of the participant, or the participant's spouse or dependent, a loss of the participant's property due to casualty or other similar extraordinary and unforeseeable circumstances due to events beyond the participant's control.

These restrictions effectively prohibit the early distribution of deferrals subject to a "haircut" clause or forfeiture penalty.

Initial Election

The nonqualified deferred compensation plan must require participants to make an initial deferral election (including timing and form of distribution elections, if applicable) in the taxable year before the year in which services to which the deferred compensation relates are performed. For example, if a participant wants to defer a portion of salary earned in 2005, he or she must elect to defer such salary amount before the end of 2004. Elections with respect to performance-related compensation based on services performed over a period of at least 12 months may be made up to six months before the end of the service period. Newly-eligible participants in a deferred compensation plan may make an initial deferral election within 30 days of their date of eligibility.

Changes to Timing and Form of Payment

A nonqualified deferred compensation plan may allow subsequent elections to delay payment or change the form of payment only if certain requirements are met. The election must be made at least 12 months in advance of the scheduled payment date, cannot be effective until at least 12 months after the election date and must defer receipt of the payment by at least five years from the otherwise applicable date (except in the case of distributions related to death, disability or unforeseeable emergency). For example, if a participant's scheduled payment date is December of 2007, an election to delay payment must be made by December of 2006 for a new payment date of December 2012 or later (and such election will not be effective until a year after the date the election is made).

No-Acceleration

The nonqualified deferred compensation plan may not permit the acceleration of previously scheduled distributions, except as may be provided by Treasury regulations. For example, if a participant had previously elected to receive distributions at the *later* of separation of service and age 65, the participant cannot subsequently elect to receive distributions upon the *earlier* of separation of service and age 65.

Off-Shore Trusts

The new legislation substantially curtails the funding of deferred compensation through off-shore trusts. Participants will be subject to immediate

taxation of any assets held in an off-shore trust (even if such assets are subject to the claims of general creditors) unless substantially all of the services to which the nonqualified deferred compensation relates are performed in a foreign jurisdiction, or as otherwise provided by Treasury regulations.

Financial Health Triggers

Deferred compensation is taxable on a current basis if a trust's assets become restricted to the provision of deferred compensation benefits due to a decline in the employer's financial health. The tax event is the earlier of either when the assets are restricted or when the plan provides the assets will be restricted. For example, if a plan provides that upon a change in the company's financial health, assets will be transferred to a rabbi trust, such assets will be subject to immediate taxation.

Reporting Requirements

For future enforcement purposes, amounts deferred will be required to be reported on the participant's Form W-2 (or Form 1099) for the year deferred, even if the amount is not currently includible in income for that taxable year.

Amounts includible in income under the Act are subject to Federal income tax withholding requirements and are required to be reported on the participant's Form W-2 (or Form 1099) for the year includible in income.

Effective Date

The Act is effective with respect to amounts deferred after December 31, 2004. Present law applies with respect to amounts deferred before January 1, 2005, as long as there was no material modification to the plan after October 3, 2004, but amounts deferred in taxable years beginning before January 1, 2005 will be subject to the new legislation if the plan was materially modified after October 3, 2004.[7]

Although it not completely clear, many commentators believe that amounts deferred, but not vested before January 1, 2005 will be subject to the Act. (While the Act itself provides that its requirements apply to "amounts deferred after December 31, 2004", the Summary of the Conference Committee Report specifies that an amount is considered deferred before January 1, 2005 if the amount is earned and vested before such date.)

Within 60 days after enactment, Treasury regulations should provide guidance for amending plans adopted before December 31, 2004 to conform to the Act with respect to amounts deferred after December 31, 2004 and to allow participants to terminate their participation or cancel outstanding elections for amounts earned after December 31, 2004. Treasury regulations may provide exceptions to certain requirements during the transition period for plans coming into compliance with the provision.

A complete review of nonqualified deferred compensation plans as well as deferral election procedures in light of the new legislation should be undertaken prior to year-end 2004 in order to avoid any potential adverse tax impact on executives in 2005. If you have any questions about this Client Alert, please contact Joseph Yaffe in our Silicon Valley Office, any member of the Firm's Benefits and Compensation Group or any of the following attorneys.

Endnotes

[1] The final bill passed by the House and the Senate reflects the conference agreement between the House proposal and the Senate proposal, the Jumpstart Our Business Act, S. 1637.

[2] A plan includes any agreement or arrangement, including an agreement or arrangement that covers just one person.

[3] The legislative history notes that a nonqualified deferred compensation plan does not include the grant of employer stock options with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does

not include a deferral feature other than the right to exercise the option in the future.

[4] Under both current law and the Act, deferred compensation is not taxable until vesting requirements are satisfied.

[5] Immediate taxation, interest and the additional income tax only apply to each participant for whom the requirements are not met, rather than all plan participants.

[6] Key employee is defined in Section 416(i) of the Code as “an employee who, at any time during the plan year, is (i) an officer of the employer having an annual compensation greater than $130,000, (ii) a 5-percent owner of the employer or (iii) a 1-percent owner of the employer having an annual compensation from the employer of more than $150,000.” For purposes of clause (i), no more than 50 employees (or, if lesser, the greater of 3 or 10 percent of the employees) are treated as officers.

[7] The addition of any benefit, right or feature is a material modification. The exercise or reduction of an existing benefit, right or feature is not a material modification.

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