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Employee Benefits Briefing

A bulletin designed to keep clients and other friends informed on employee benefits law matters

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NONQUALIFIED DEFERRED COMPENSATION IN A CHANGING ENVIRONMENT

On October 22, 2004, President Bush signed into law a large corporate tax bill known as the American Jobs Creation Act of 2004. At a svelte 650 pages (not to mention the 600-page Conference Report), the new law changes a myriad of provisions affecting corporate taxes, with 16 of those pages overhauling the rules applicable to nonqualified deferred compensation plans.

At one level, the new law confirms and codifies most of the existing rules that apply to "plain vanilla" nonqualified deferred compensation plans. At other important levels, however, it makes substantial changes to existing rules (many of which are ill defined), and its reach encompasses many types of plans (such as equity-based compensation plans and defined benefit SERPs) that have historically been viewed differently from traditional deferred compensation plans.

Plans Covered

The new law generally applies to any plan that provides for the deferral of compensation. In addition to plans normally thought of as deferred compensation plans, the new law also covers:

- Excess benefit plans and "SERPs."
- Certain types of equity-based compensation, such as discounted stock options, restricted stock units, phantom stock and stock appreciation rights.
- Code Section 457(f) "substantial risk of forfeiture" plans of governmental or tax-exempt employers.
- Agreements or arrangements that cover one person.

In addition, the law is not limited to a plan between an employee and an employer. Thus, a director fee deferral plan would be subject to these rules.

Plans **Not** *Covered*

The new law exempts many types of broad-based plans that could be viewed as deferring income. These types of plans include:

- Qualified employer plans.
- Qualified retirement plans (pension, profit sharing, 401(k), 403(b), ESOP, simplified employee pension, SIMPLE, etc.).
- Eligible deferred compensation plans of governmental or tax-exempt employers (Code Section 457(b) plans).
- Qualified governmental excess benefit arrangements (Code Section 415(m) plans).
- Vacation leave plans.

- Sick leave plans.
- Compensatory time plans.
- Disability pay plans.
- Death benefit plans.

The Conference Report provides that stock options (whether incentive stock options or nonqualified stock options) issued at no less than fair market value under a plan without a deferral feature are not considered deferred compensation plans. Also, the new law is not intended to change the taxation of Code Section 423 employee stock purchase plans.

Finally, the Conference Report provides that an annual bonus plan under which bonuses are paid within 2 1/2 months after the end of the tax year during which services were performed is not itself a deferred compensation plan.

Timing of Initial Deferral Election

Base Salary: The deferral election must be made in the year prior to the year in which the salary is earned. However, if an employee first becomes eligible mid-year, the election must be made within 30 days after an employee first becomes eligible.

Performance-Based Compensation: The timing rules depend on the performance period and what is ultimately defined as "performance-based compensation."

> *Performance period of less than 12 months*: the election must be made before the performance period begins.
>
> *Performance period of 12 months or more*: the election must be made no later than 6 months before the end of the performance period.

The IRS has been directed to define the term "performance-based compensation." In this regard, the Conference Report states that "performance-based compensation" will be defined by the IRS to include compensation to the extent that the amount is: (1) variable and contingent on the satisfaction of preestablished organizational or individual performance criteria and (2) not readily ascertainable at the time of the election.

The Conference Report also states that it is intended that performance-based compensation may be required to meet certain requirements similar to those under Code Section 162(m) (relating to the $1-million deductibility cap for publicly traded companies), but would not be required to meet all requirements under that Code Section.

Time and Form of Distribution

The time and form of distribution must be specified at the time of initial deferral.

- A plan may specify the time and form of distribution in its terms (*e.g.*, lump sum paid 30 days after separation from service).
- If a plan permits a participant to elect the time and form of distribution, that election must comply with the new rules at the time it is made.
- A plan may permit different forms of benefits at different times (*e.g.*, an annuity at age 65, but a lump sum upon disability).

Subsequent Deferral Elections

The new law permits subsequent deferral elections, but is generally designed to make them unpalatable.

- The subsequent election cannot be effective for at least 12 months after the date on which the election is made.
- An election related to a distribution to be made at a specified time may not be made less than 12 months prior to the date of the first scheduled payment. For example, if a series of installments is to begin January 1, 2008, a subsequent

election to further defer payment must be made on or before December 31, 2006.

- The subsequent deferral must be for a period of at least 5 years from the date the first payment would otherwise have been made.

- Amounts deferred under a subsequent election *cannot* be accelerated except in the case of death, disability or unforeseeable emergency. Thus, if a plan would provide for acceleration of the deferral upon separation from service (which is permissible in connection with an initial deferral), it cannot provide for such acceleration after a subsequent deferral.

Distribution Events

- *Separation from service*

  In the case of "key employees" of *publicly traded employers*, distributions may not occur before 6 months after separation from service. "Key employee" means officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), 5% owners, and 1% owners having annual compensation greater than $150,000 (net adjusted for inflation).

- *Disability*

  A Participant is disabled if:

  (i) he/she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or

  (ii) he/she is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

- *Death*

- *Specified Time*

  Amounts payable when an employee attains age 65 are payable at a specified time. Similarly, amounts payable at a fixed date (*e.g.*, January 15, 2008) are payable at a specified time. However, amounts payable when a child begins college *are not* payable at a specified time, but payable upon the occurrence of an event and not permitted under the new rules.

- *Change in ownership of the employer (to the extent defined by the IRS)*

  In this regard, the Conference Report states that the IRS should use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of Code Section 280G.

- *Unforeseeable emergency*

  This term is defined as a severe financial hardship to the participant resulting from an illness or accident of the participant, the participant's spouse, or a dependent (as defined in Code Section 152(a)) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. This is a

much narrower standard than the 401(k) hardship withdrawal standard.

The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution.

Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

No Acceleration of Distributions

As a general rule, the payment of amounts that are deferred cannot be accelerated even with a discount "haircut" feature. However, certain limited exceptions apply, and the IRS may permit other exceptions through regulations.

For example, it is permissible for a plan to provide that an initial deferral election automatically accelerates upon the participant's termination of employment.

Note: This acceleration provision is not permissible with respect to subsequent deferrals.

Changes in the form of distribution that accelerate payments would violate this rule. Thus, a participant could not change a 10-year installment election to a 5-year installment election.

The Conference Report indicates that the IRS will issue regulations that will permit distributions to be accelerated for reasons beyond the control of the participant. Examples are:

- Acceleration because of Federal conflict of interest requirements.
- Acceleration under a court-approved settlement incident to divorce.
- Withholding of an employee's share of employment taxes from the account.
- Acceleration to pay tax liability upon vesting in a Code Section 457(f) "substantial risk of forfeiture" plan.
- Automatic cash-out of minimal amounts (*e.g.*, $10,000).

Penalties for Violating these Rules

If the new rules are violated, deferrals are included in current income, plus the employee will be required to pay interest at the underpayment rate plus 1% applied back to the date when amounts were first deferred (or if later, when such amounts were no longer subject to a substantial risk of forfeiture).

The amount required to be included in income is also subject to a 20% additional tax.

These additional taxes are imposed only with respect to the participant(s) for whom these requirements were violated. For example, if deferral election requirements are violated for one individual, only that individual must pay the taxes.

Similarly, if a plan provision that applies to a subset of participants violates the rules, only that subset of participants is taxed.

However, all participants could be taxed if a provision that applies to all participants violates the rules.

Miscellaneous Changes

Offshore Trusts: Although U.S. "rabbi trusts" continue to be permissible vehicles for deferred compensation plans, if assets are moved outside of the U.S., they are considered taxable and subject to the taxes imposed for violating these rules.

Financial Health Triggers: A plan may not provide for funding of the benefits in connection with a change in financial health of the employer, even if the funded

amounts remain subject to the general claims of creditors in a "rabbi trust."

Reporting Requirements

Beginning with 2005, amounts deferred are to be reported on a Form W-2 or 1099, as applicable, for the year deferred even if the amount is not currently includible in income for that taxable year.

The IRS may provide in regulations that there is a minimum threshold for reporting deferrals.

The IRS may also provide guidance on how deferral amounts should be reported when they are not readily ascertainable (*e.g.*, in the context of a defined benefit SERP). The Conference Report indicates that the rules should be similar to the rules currently in force for purpose of determining the amount subject to FICA taxes.

Effective Dates

The new law is effective for amounts deferred on and after January 1, 2005. An amount is considered deferred before January 1, 2005 if it is earned and vested before that date.

The new law will not apply to amounts deferred through December 31, 2004, provided that the plan under which the amount is deferred is not materially modified after October 3, 2004. For example, the addition of a 10% "haircut" feature would be considered a material modification. However, the removal of a 10% "haircut" feature (or any other action that is adverse to the participants under the plan) would not be considered a material modification.

Recommended Steps

In light of the short time before the new law takes effect, plan administrators and plan sponsors should consider taking the following steps:

1. *INVENTORY all deferred compensation and equity-based arrangements*. As noted above, deferred compensation arrangements may be found in traditional nonqualified deferred compensation plans, including rabbi and secular trusts, as well as in a variety of programs, agreements, policies, and arrangements, such as individual employment, SERP, stock option, or change-in-control agreements. Also, some arrangements may be only for top executives and other arrangements may be only for nonemployee directors. In addition, equity-based and other incentive compensation arrangements may contain deferral provisions or allow the grant of equity awards that now may fall under the definition of "nonqualified deferred compensation."

2. *"SEAL AND SECURE" all existing deferred compensation and equity-based arrangements*. The new legislation, although not effective until January 1, 2005, will impact any existing arrangement that is "materially modified" after October 3, 2004. It is critical that absolutely no changes be made to these existing arrangements, or else the arrangement may lose grandfather and transition protection. The law requires that the Treasury Department issue transition and other guidance within 60 days of enactment of the new law. Accordingly, until then, "first do no harm."

3. *IMPLEMENT new 2005 tax-compliant deferred compensation programs*. Companies should not be discouraged from allowing executives to defer 2005 compensation, but should do so prudently. Thus, we recommend that upcoming enrollments for 2005 compensation reflect compliance with the new law. Unfortunately, there are still many open issues that won't be resolved until the Treasury Department and the IRS issue regulations (as noted above, some of these are expected within 60 days of enactment of the new law).

4. *REVIEW all existing equity-based and other incentive compensation arrangements*. It is likely that restricted stock units (RSUs), stock appreciation rights (SARs), discounted stock options, and other equity-based and cash-based incentive awards and programs will be affected by the new law. Accordingly, companies will need to review the terms and conditions of their

"traditional" equity-based and cash-based incentive programs to ensure that future grants are 100% compliant. Also, existing equity-based compensation plans and awards must be reviewed, since any existing award not vested by December 31, 2004 will be subject to these new rules. As a result, companies may need to revise outstanding awards in order not to run afoul of the new law, such as providing for immediate distribution upon vesting without opportunity to defer.

5. *REVISIT the company's executive compensation policies*. Deferred compensation is not dead – just changed. Whether a company should continue to have a deferred compensation program as part of its executive compensation policy is still a company-by-company decision affected by culture, history, current tax rates, program objectives, and a company's overall compensation philosophy.

If you have any questions regarding this amendment, please call any Vedder Price attorney with whom you work.

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