

## ***SIGNIFICANT NONQUALIFIED DEFERRED COMPENSATION PLAN LEGISLATION HEADED FOR PRESIDENT'S DESK***

New legislation that promises to significantly alter the landscape for nonqualified deferred compensation plans – plans typically designed for executives to supplement company-sponsored retirement programs - is on its way to the President's desk where it will likely be signed into law. The American Jobs Creation Act of 2004 ("AJCA") (H.R. 4520), passed this week by Congress, contains a number of provisions affecting the design and administration of deferred compensation plans that have been under discussion throughout the industry for the past few years. The good news is that the changes passed are not as restrictive as originally proposed; the bad news is the new law applies beginning in 2005, so that clients will need to begin considering the appropriate design changes as soon as possible.

### **Applicability of the New Rules**

The AJCA makes changes in the tax rules applicable to nearly all nonqualified deferred compensation arrangements – including elective and non-elective deferred compensation plans, supplemental executive retirement plans (SERPs), excess benefit plans, stock appreciation rights and other arrangements that defer current compensation into the future. Also included within the AJCA's scope are governmental and tax-exempt deferred compensation arrangements (other than eligible 457(b) arrangements), as well as severance plans that pay benefits upon a change in corporate control. Specifically excluded are incentive stock options (ISOs) and employee stock purchase plans (ESPPs). Not specifically addressed is whether and how the new rules will affect grants of restricted stock, phantom stock plans and discounted options.

### **Tax Consequences of Non-Compliance**

Failure to follow the new rules will subject participants to harsh tax consequences. Where a plan fails to comply with the new rules with respect to a specific participant, all prior compensation deferred by that participant under the plan is included in the participant's gross income and treated as wages, unless subject to a substantial risk of forfeiture. The participant is also subject to an excise tax equal to 20% of the amount included in income, and must pay interest on the previously deferred amounts included in gross income.

### **Key Rules that Apply to Post-2004 Deferrals**

The AJCA formalizes some general principles that have been standard practice for deferred compensation plans, but also specifically defines a number of situations that previously were left open to interpretation, including:

- **Restrictions on Deferral Elections.** Elections to defer compensation must be made before the tax year in which the services are rendered (i.e., an election to defer compensation for services performed in 2005 must be made no later than

December 31, 2004). The rules on deferral elections for performance-based compensation (e.g., bonuses) are a bit more flexible.

- Restrictions on Distribution Events. Deferred compensation plans must be narrowly designed to permit distributions only on specifically enumerated events (e.g., termination of employment, death, disability, passage of a specified length of time, a corporate change in control or an unforeseeable emergency). Plan termination is not a distribution event.
- Accelerated Distributions Prohibited. The acceleration of distributions for any reason other than unforeseeable emergency is prohibited. The Secretary of the Treasury has been instructed to issue Treasury Regulations that define the circumstances under which these distributions will be allowed.
- Restrictions on Distribution Elections. Distribution elections generally must be made at the time deferral elections are made. An election to postpone a distribution or change the form of payment is generally permitted, but it must be made at least 1 year before the date the benefit otherwise becomes payable, and must defer the receipt of payments for at least 5 years from the date the first payment would otherwise have been made.
- Rabbi Trust Restrictions. Where a plan is funded using an offshore rabbi trust, the trust will be treated as a funded arrangement generally subjecting participants to immediate taxation. Similar treatment applies to domestic rabbi trusts, which use the employer's financial health as a trigger to restrict the use of trust assets to pay plan benefits (even if the benefits continue to be subject to claims of the employer's general creditors).
- New Reporting Requirement. Amounts deferred must be reported on an individual's W-2 or 1099 (as applicable), even if the amounts are not currently includible in income when earned.

### **Action Steps**

Employers should immediately begin identifying which plans and arrangements are subject to the new rules. Because the AJCA applies to more than just "traditional" deferred compensation plans, arrangements which have not historically been treated or viewed as nonqualified deferred compensation plans should be reviewed to determine whether they are subject to the new rules. (For example, it is possible that an employee's employment contract could include a provision that renders it a nonqualified deferred compensation plan within the meaning of the AJCA.)

Employers have a very short timeframe in which to amend their plans (or adopt new plans) to comply with the new requirements: the AJCA applies to amounts deferred after December 31, 2004. In addition, amounts deferred before January 1, 2005, become subject to the AJCA if the underlying deferred compensation plan is "materially modified" after October 3, 2004 (e.g., an amendment after 10/3/04 to accelerate vesting could subject the plan to the new rules). Thus, to

protect existing plans' continued ability to rely on the old rules, any future plan amendments should be very carefully reviewed before being adopted. For public companies, changes to these plans may require amended SEC filings.

It is unclear how pre-2005 participant elections made under the old rules will be treated under the new rules. It is also unclear whether the AJCA applies to benefits earned but not vested prior to January 1, 2005; although, at this time it appears benefits that have not vested by January 1, 2005, will be subject to the new rules. Regulations dealing with these issues are expected to be issued within 60 days of the AJCA's enactment.

Finally, the new rules are complicated and have the potential to significantly limit benefits earned under these plans. Consequently, participants will undoubtedly be concerned about, and will need to be informed about, the new rules and how their existing and future benefits will be impacted. As with other plan changes that might have a significant impact to a participant's tax obligations, plan communications and explanations should be carefully drafted after design changes are considered and implemented.

*Attorneys in Lane Powell Spears Lubersky's Employee Benefits & Executive Compensation, Taxation, and Corporate Finance & Securities Practice Groups are available to advise employers on the new requirements, to help document and implement any changes, and to help prepare participant communications materials.*

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