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—LEGISLATION UPDATE —

**Provisions Affecting Deferred Compensation  
in the American Jobs Creation Act of 2004**

The American Jobs Creation Act of 2004 was signed by the President on October 22<sup>nd</sup>. The Act makes vested nonqualified deferred compensation taxable on a current basis unless certain requirements, which are significantly different than the requirements currently in effect, are met. As a result of the broad coverage of what is considered to be “nonqualified deferred compensation,” the Act has implications that affect traditional deferred compensation plans, as well as stock appreciation rights, restricted stock units and nonqualified retirement plans.

This Legislation Update discusses the deferred compensation provisions of the Act. Our October 12<sup>th</sup> alert letter highlighted major implications of the provisions.<sup>1</sup>

**Wide Variety of Affected Arrangements**

The Act sweeps in a wide variety of compensation arrangements into the definition of “nonqualified deferred compensation plan” under new Section 409A of the Internal Revenue Code (in addition to traditional deferred compensation plans) as indicated in the following table.

<b>Plans Subject to Section 409A</b>	<b>Plans <u>Not</u> Subject to Section 409A</b>
<ul style="list-style-type: none"><li>• Discount stock options (i.e., options with an exercise price less than fair market value on date of grant)</li><li>• Restricted stock units and deferred stock units</li><li>• Performance share units (i.e., share units payable if multi-year performance conditions are met)</li><li>• Stock appreciation rights (SARs)</li><li>• Phantom stock</li><li>• Employee stock purchase plans that do not satisfy Internal Revenue Code Section 423</li><li>• Supplemental retirement plans and excess retirement plans (i.e., plans providing benefits or contributions in excess of the limits for tax-qualified retirement plans)</li><li>• Severance plans permitting elections between lump sum and installment payments</li></ul>	<ul style="list-style-type: none"><li>• Stock options on employer stock with an exercise price at least equal to fair market value on grant date</li><li>• Restricted stock</li><li>• Performance shares (if shares are issued at grant subject to forfeiture if performance conditions are not met)</li><li>• Employee stock purchase plans satisfying Internal Revenue Code Section 423</li><li>• Tax-qualified retirement plans under Internal Revenue Code Sections 401(a), 403(a) and 403(b) and eligible deferred compensation plans of governmental and tax exempt employers under IRC Section 457(b)</li></ul>

<sup>1</sup> Refer to our letter dated 10/12/04, which is available on our website at [http://www.fwcook.com/alert\\_letters/10-12-04%20Heads-Up%20on%20Deferred%20Compensation....pdf](http://www.fwcook.com/alert_letters/10-12-04%20Heads-Up%20on%20Deferred%20Compensation....pdf)

For this purpose, an employment or other agreement with one person providing such an arrangement will be considered to be a nonqualified deferred compensation plan. Directors, consultants and other independent contractors are also affected if covered by arrangements considered to be subject to Section 409A.

### **Key Requirements**

Compensation deferred under a nonqualified deferred compensation plan will be subject to current tax unless it is subject to a substantial risk of forfeiture or meets the following requirements:

- **Initial Deferral Election** -- The initial election to defer (including the form of payment) must be made during the calendar year prior to the year in which the compensation is earned, unless otherwise provided in regulations, or within 30 days after initial participation in the deferred compensation plan
  - For example, the election to defer a bonus earned in calendar year 2005, which would typically be payable in early 2006, must be made by December 31, 2004
  - IRS guidance is to be issued concerning the timing of elections under plans of fiscal year employers, which is likely to provide that the initial deferral election for bonus compensation must be made during the fiscal year prior to the fiscal year in which the bonus is earned
    - For example, the election to defer a bonus earned in the employer's fiscal year beginning October 1, 2005, which would typically be payable in November or December 2006, must be made by September 30, 2005
  - If bonus compensation (annual or long-term) is performance-based, the initial deferral election can be made up to 6 months before the end of the performance period. In order to be performance-based:
    - The performance period must be at least 12 months;
    - The amount of the bonus must be variable and contingent on the satisfaction of preestablished performance criteria; and
    - Performance criteria for the bonus must be established in writing within 90 days after the start of the performance period
- **Subsequent Election** -- A subsequent election to further defer payment or change form of payment must not be effective for at least 12 months
  - Payment under a subsequent election may not be made for at least 5 years from the original payment date, except in the event of death, disability or an unforeseeable emergency
  - If payment was to be made in installments, the election must be made at least 12 months prior to the payment date of the first installment

- Distributions -- The plan may not provide for (or permit) distribution except upon:
  - the participant’s separation from service, subject to a 6-month delay for certain “key employees” of public companies<sup>2</sup>
  - a specified time or under a fixed schedule specified as of the date of deferral
  - disability (as defined in Section 409A) or death
  - a change in control to the extent provided in guidance issued by the IRS
  - the occurrence of an unforeseeable emergency
  
- No Acceleration -- The plan may not provide (or permit) acceleration of the time or schedule of payment of deferred amounts is permitted, except as may be provided in regulations

**Current and Increased Tax If Requirements Not Met**

If a deferred compensation arrangement does not meet the requirements of Section 409A, the amount deferred will be subject to current income taxation, as well as increased tax equal to:

- An additional 20% of the original deferral, as well as any earnings credited on the deferral, and
- Interest at the underpayment rate (5% effective October 1) plus 1% on the tax that should have been paid on the amount of the original deferral and any related earnings

If deferred compensation not meeting the requirements discussed above is subject to a substantial risk of forfeiture (i.e., vesting), it will not be taxable until it vests. At vesting, the deferred amount (and any related earnings) also will be subject to the additional 20% tax, but typically will not be subject to the tax based on interest.

Subsequent earnings attributable to deferred compensation not meeting the requirements would also be subject to immediate taxation, as well as the additional 20% tax.

*Plan Terms and Operation.* If the terms of the deferred compensation plan do not satisfy the requirements discussed above, all deferrals under the plan are subject to current tax and the increased tax (or, if later, when the deferred compensation vests). If the plan’s terms meet the requirements, but the plan is operated in a manner contrary to the requirements, only the affected participant is subject to the immediate and increased tax. Under certain circumstances, all participants will be affected by failure to operate the plan in accordance with its terms and the requirements of Section 409A.

In each of the following examples, it is assumed that all deferrals are made for compensation earned in 2005 and subsequent years.

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<sup>2</sup> Generally, key employees (as defined under the special rules for top-heavy retirement plans) are limited to the company’s 50 highest-paid officers whose total annual compensation exceeds \$135,000 in 2005 (adjusted for cost-of-living increases)

- Example 1 -- A plan permits participants to receive a distribution to pay for college tuition of a participant's dependents. Since that would not be a permissible distribution under Section 409A, all participants would be subject to current and increased tax on all deferrals under the plan (and on any future earnings credited to the deferrals).
- Example 2 -- A participant with a child who is age 8 elects to receive payment of 50% of the participant's account in 10 years. The timing of the payment complies with Section 409A and as a result the participant would be only be subject to tax on the portion of the account which is distributed to the participant when the distribution is made. No additional tax would be applicable.
- Example 3 -- An excess benefit retirement plan provides that payments will be made in the same form as payment of the participant's benefits under the related tax-qualified retirement plan. All participants would be subject to current and increased tax on all plan deferrals (as well as on future earnings) since the election of the form of payment under the tax-qualified retirement plan can be made up and until a short time (usually no more than 60 days) before benefit payments are to commence.
- Example 4 -- A participant is permitted to make an initial deferral election after the deadline specified in a plan, the terms of which comply with the requirements of Section 409A. Only that participant will be subject to current and increased tax on the deferred amount.
- Example 5 -- A participant with a \$500,000 balance is permitted to receive a distribution of \$75,000 for a "financial hardship" which does not meet the requirements of an unforeseeable emergency. The participant may be subject to current and increased tax on the full \$500,000 balance, rather than only on the \$75,000 that was distributed.
- Example 6 -- A plan that has nine participants makes in-service distributions to four participants over a two-year period for reasons which do not meet the requirements of Section 409A. The IRS may determine that as a result of the operation of the plan, the other five participants are subject to current and increased tax on their account balances under the plan because they could have received accelerated distributions on request.

### **W-2 Reporting**

Employers will be required to include on the annual Form W-2 filed with the IRS reporting an employee's compensation the total amount of deferred compensation under a plan meeting the requirements of the Act. The IRS may establish a minimum amount of deferrals below which reporting will not be required.

### **Effective Dates**

The requirements of the Act are applicable to amounts deferred in years beginning after December 31, 2004. Amounts deferred before the effective date are not subject to the Act, even if there are subsequent deferrals or changes in the form of payment, unless the plan under which the deferral is made is materially modified after October 3, 2004. Within 60 days after

enactment, the IRS is to issue guidance that permits a limited transition period for a deferred compensation plan to be amended:

- To permit participants in a plan adopted before December 31, 2004 to terminate their participation or cancel outstanding deferral elections for amounts earned after December 31, 2004, provided such amounts are includable in income at the earlier of the date earned or when no longer subject to a substantial risk of forfeiture, and
- To conform to the Act's requirements

*Transition Period.* According to the Conference Report:

- The IRS guidance may provide exceptions to certain requirements (e.g., the rules regarding timing of elections) during the transition period for deferred compensation plans which come into compliance with the Act, and
- The IRS is expected to provide deferred compensation plans a reasonable time after guidance is issued to be amended in accordance with the Act's requirements

### **Implications and IRS Guidance**

*Implications.* Among the major implications of the Act, which were highlighted in our October 12<sup>th</sup> alert letter, are the following:

- Traditional SARs giving recipients the right to exercise and receive payment at any time after vesting would no longer be viable since they would be subject to immediate tax on vesting (unless exempted by IRS guidance), as well as the additional 20% tax;
- Discount stock options will be subject to current tax on vesting, as well as the additional 20% tax;
- Elections to change the form or timing of payment will require a delay in the commencement of payments for at least 5 years from the previously scheduled payment date;
- Acceleration of payments is not permitted. As a result, a participant could not change the form of payment of deferred amounts from installments over a 10-year period to a lump sum; and
- Traditional stock unit designs based on service or performance vesting criteria with payment on vesting are not adversely affected by the deferred compensation provisions of the Act

*IRS Guidance.* There are many significant aspects of the deferred compensation provisions of the Act which are unclear and will need to be clarified by guidance to be issued by the IRS, including:

- Whether any exceptions will be provided with respect to stock appreciation rights (which is not currently expected, other than possibly for grants made prior to the completion of legislative action on October 11, 2004),
- The amount to be included in income for stock appreciation rights and stock options, which are subject to immediate taxation on vesting, and
- Whether bonus deferral elections made during 2004 for bonus compensation earned in 2004 will be permissible if the bonus is “vested” as of December 31, 2004

Amendments. Employers should not amend their deferred compensation plans in advance of the guidance to be issued by the IRS.

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This letter is intended to alert compensation professional about developments that may affect their companies, and should not be considered or relied upon as legal advice. Specific questions about the applicability of the Act to compensation arrangements should be discussed with appropriate counsel. General questions applicable to the Act may be directed to Richard Alpern in our New York office at 212-986-6330 or by email at [ralpern@fwcook.com](mailto:ralpern@fwcook.com). This letter and other published materials are available on our website, [www.fwcook.com](http://www.fwcook.com).