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New York • Chicago • Los Angeles

October 12, 2004

## **HEADS-UP ON DEFERRED COMPENSATION LEGISLATION**

### **American Jobs Creation Act of 2004 Approved by Congress**

The American Jobs Creation Act of 2004 was approved by the Senate on October 11 (following approval by the House of Representatives on October 7) and sent to the President for signature. The Act makes a number of significant changes to the requirements that must be met by deferred compensation arrangements in order to avoid immediate taxation. In light of the broad coverage of what is considered to be “deferred compensation,” the Act has far-reaching implications which potentially affect a wide variety of compensation vehicles. This alert letter highlights major implications of the deferred compensation provisions in the Act. A subsequent alert letter will discuss the provisions in more detail.

**Annual Bonus Deferrals.** Elections to defer annual bonuses will need to be made before the start of the year in which the bonus is earned, unless the bonus plan meets specified criteria for being performance-based. If the criteria are met, the election may be made no later than 6 months prior to the end of the performance period. In order to be performance-based:

- The performance period cannot be shorter than 12 months.
- The amount of the bonus must be variable and contingent.
- Performance criteria for the bonus must be established in writing within 90 days after the start of the performance period.

**Stock Options.** In order for a stock option to avoid treatment as deferred compensation (which could result in current tax as the option vests), it must be granted at no less than the fair market value of the employer’s stock on the date of grant and not include a deferral feature other than the right to exercise the option in the future.

**Stock Appreciation Rights (SARs).** Traditional SARs (grants under which the recipients decide when to exercise and receive payment) will no longer be viable since they will be subject to tax as they vest. SARs which are vested as of December 31, 2004 will not be affected by the Act, provided there is no material modification after October 3, 2004 to the plan under which the SARs are granted or to the grant agreements for the SARs.

**Restricted Stock Units (RSUs).** RSUs will be less attractive under the Act because elections to defer payment of RSUs will:

- Have to be made at least 12 months in advance of the scheduled payment date.
- Require payment to be deferred for at least 5 years from the previously scheduled payment date.

Elections with respect to RSUs which are vested as of December 31, 2004 will not be affected by the Act if there is no material modification after October 3, 2004.

**Long Term Performance Awards.** Initial deferral elections can be made no later than 6 months before the end of the performance period, as long as the criteria discussed above for performance-based awards are satisfied.

**Supplemental Executive Retirement Plans (SERPs).** If an election is made to change the form of payment, commencement of payments must be delayed for at least 5 years from the previously scheduled commencement date. SERP payments can not be accelerated from what is specified in the initial election. In other words, an election of installment or annuity payments cannot be changed to a lump-sum payment; it is permissible to change an election of a lump-sum payment to installment or annuity payments.

**Acceleration of Payments under Traditional Deferred Compensation Plans.** Discretionary distributions with a “10% haircut” will no longer be allowed. Instead of hardship, an accelerated distribution can only be made in the event of “unforeseeable emergency.”

**Payments to Key Employees.** Payments on separation from service to “key employees” of public companies (generally limited to no more than the highest-paid 50 officers) must be delayed for at least 6 months, including payments after a change in control.

**Directors.** The new deferred compensation provisions apply to deferrals by directors as well. Since compensation of directors is rarely performance-based, the initial deferral election generally will have to be made before the start of the year in which the compensation is earned.

**Effective Date.** The Act is effective for deferrals in years beginning after December 31, 2004. In order for an amount to be treated as deferred before the effective date, it must be earned and vested before the effective date.

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This letter is intended to alert compensation professionals about developments that may affect their companies. General questions applicable to deferred compensation legislation may be directed to Richard Alpern in our New York offices 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).