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— PROPOSED LEGISLATION UPDATE —

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

On June 17, the House of Representatives passed the American Jobs Creation Act of 2004 (“AJC”), which if approved in its current form, will make deferred compensation taxable on a current basis unless it meets certain requirements. The provisions in AJC are very similar to the provisions in the Jumpstart Our Business Strength Act of 2004 (“JOBS”), which was passed by the Senate on May 11. The House and Senate are expected to meet in conference to reconcile differences in the two versions shortly after the July 4<sup>th</sup> holiday weekend.

This Legislation Update discusses the AJC deferred compensation provisions and the significant differences from the JOBS provisions, which were discussed in our May 29<sup>th</sup> alert letter.<sup>1</sup> Under AJC, deferred compensation that is subject to vesting will not be taxable until the vesting requirements are satisfied. Deferred compensation not subject to vesting must meet certain requirements or be subject to immediate income taxation, plus increased tax equal to:

- Interest at the underpayment rate (4% effective July 1) on the tax that should have been paid on the amount of the original deferral and any earnings credited to the deferral; plus
- An additional 1% interest on the tax that should have been paid on the deferral and any earnings (JOBS would impose an additional 10% tax on the amount of the original deferral and any earnings).

The key requirements in order for vested deferred compensation to avoid current tax are:

- The initial election to defer 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 2005 which would be paid in 2006 must be made before end of 2004

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<sup>1</sup> Refer to our letter dated 5/29/04, which is available on our website at [http://www.fwcook.com/alert\\_letters/5-29-04%20JOBS%20Provisions%20Affecting%20Deferred%20Compensation.pdf](http://www.fwcook.com/alert_letters/5-29-04%20JOBS%20Provisions%20Affecting%20Deferred%20Compensation.pdf)

- According to the House Ways and Means Committee report on AJC, the IRS is expected to issue regulations providing that, in appropriate circumstances, the election to defer a long-term bonus earned over a multi-year performance period could be made after the beginning of the performance period, provided the election is made at least 12 months before the bonus is otherwise payable (this was not clear under JOBS)
- A subsequent election to further defer payment or change form of payment must not be effective for at least 12 months (under JOBS only one subsequent election is permitted)
  - 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
- No acceleration of the time or schedule of payment of deferred amounts is permitted, except as may be provided in regulations
- There can be no distributions prior to (i) separation from service, subject to a 6-month delay for certain “key employees” of public companies, (ii) a specified time or under a fixed schedule, specified under the plan as of the date of deferral, (iii) disability or death, (iv) a change in control (JOBS also requires a 1-year delay for Section 16 officers), or (v) the occurrence of an unforeseeable emergency

AJC excludes two significant JOBS provisions. Specifically, AJC does not:

- Require that the deferred compensation plan restrict investment options to those available under the employer’s tax-qualified defined contribution plan; or
- Prohibit the deferral of gains from stock option exercises or restricted stock awards.

### **Effective Dates**

The effective dates in AJC and JOBS differ considerably and would need to be reconciled in conference prior to becoming law. Under AJC, the requirements would be applicable to amounts deferred after June 3, 2004, except for amounts deferred before January 1, 2005 under an irrevocable election or binding arrangement made before June 3, 2004 (JOBS would apply to amounts deferred or exchanged after December 31, 2004). Within 90 days after enactment, the IRS would provide guidance that permits a limited period for participants in deferred compensation plans adopted before June 4, 2004 (January 1, 2005 under JOBS) to terminate their participation or cancel outstanding deferral elections for amounts earned after June 3, 2004 (December 31, 2004 under JOBS).

## **Implications**

If enacted, the law would materially affect the way companies administer traditional deferred compensation arrangements. In addition, the provisions would eliminate the tax timing flexibility of stock appreciation rights in the absence of an interpretation by Congress or the IRS that SARs are not covered by the provisions. The provisions would also apply to restricted stock units (and deferred stock units). However, it appears but is not clear that an election to defer payment prior to vesting of restricted stock units would be treated as a “subsequent election” rather than an “initial election.”

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This letter is intended to alert compensation professional 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).