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New York • Chicago • Los Angeles

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Jobs and Growth Tax Relief Reconciliation Act of 2003

On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JAGTRRA). This letter focuses on the centerpiece of the legislation that reduces taxes on long-term capital gains and dividend income, and its potential implications on compensation design.[1]

> The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the top individual tax rate on capital gains and dividends to 15%. However, these changes will have a limited impact on compensation design since unvested equity compensation (e.g., restricted stock) will continue to be taxed at ordinary income tax rates. Earlier versions of the legislation contained provisions that would severely limit the flexibility of nonqualified deferred compensation plans. While these provisions were removed from the final Act, certain aspects will likely reappear in future congressional legislation or tax regulations.

Reduction of Tax Rate on Capital Gains

- The top individual rate on adjusted net capital gains is reduced from 20% to 15%[2]
  - The reduction in the capital gains tax rate applies to both the regular tax and the alternative minimum income tax
  - The tax rate reduction applies to assets that are held for more than one year (short-term capital gains continue to be taxed at ordinary income tax rates)
  - The tax rate reduction applies to sales that occur on or after May 6, 2003 and is scheduled to expire in 2009

Reduction of Tax Rate on Dividends

- Dividends received from domestic corporations or qualified foreign corporations[3] will generally be subject to the same tax rates as capital gains (i.e., the top individual rate of 15%)

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1 Other JAGTRRA provisions, such as accelerated reduction of individual tax rates and the increase in the alternative minimum tax exemption amount, are expected to have minimal effects on compensation design.

2 For the 10% and 15% tax brackets, the capital gains tax rate is reduced from 10% to 5%.

3 Qualified foreign corporations include foreign corporations traded on U.S. securities markets using American Depository Receipts or corporations incorporated in a U.S. possession.

— The reduction in the dividend tax rate applies to the regular tax and the alternative minimum income tax

— In order to qualify for the lower tax rate, the share of stock must be held for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date

— The legislation limits the dividends (if any) paid by regulated investment companies (RIC) or real estate investment trusts (REIT) that may qualify for the reduced tax rates

— The tax rate reduction applies to dividends received in taxable years after December 31, 2002 and is scheduled to expire in 2009

Implications

The impact of the reduced tax rates on equity compensation is limited since stock price appreciation and dividend payments attributable to unvested equity compensation are generally subject to ordinary income tax until the compensation is vested. For example, dividends paid on unvested restricted stock are subject to ordinary income tax rates.

Employees could utilize Section 83(b) elections,[4] which would allow the reduced tax rates to apply to future stock price appreciation and dividend payments of unvested equity compensation. However, these elections have certain shortcomings such as not receiving a tax credit if the compensation is ultimately forfeited and payment of the tax obligation earlier than necessary. For these reasons, it is unlikely that Section 83(b) elections will increase in prevalence.

The tax benefit of nonqualified deferred compensation (NQDC) which is invested in capital gain/dividend paying securities is reduced under the JAGTRRA. This is due to the reduction in tax rates, which increases the relative value of compensation that is immediately taxed and reinvested. However, NQDC will remain appealing since (1) the reduced tax rates do not apply to investments in money market accounts or bonds and (2) pre-tax investment will continue to be the most tax-efficient way to invest in a rising stock market.

Provisions Removed from the Final Legislation

The following provisions that were removed from the final legislation would have had a significant impact on the design of NQDC plans:

- Rabbi Trusts would be disallowed

- Distributions from NQDC plans must occur at separation from service, death, disability, or a fixed time (not event). This would preclude accelerated distributions for hardship, change-in-control ("CIC"), and elective withdrawals with a penalty

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[4] Section 83(b) elections accelerate the taxable event related to property subject to a substantial risk of forfeiture (e.g., unvested equity compensation).

- Any modification to the deferral agreement would result in immediate taxation with interest penalties

- A six-month wait would be required for distributions upon separation from service

- Stock option gains, restricted stock, and other equity-based compensation would not be eligible for deferral

- Investment alternatives must be the same as the company's qualified plan with the least investment options. We believe this was meant to preclude additional investment alternatives, but would not preclude fewer options

While these provisions were removed from the final legislation, it is likely that certain aspects will reappear in future congressional legislation or tax regulations.

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This letter is intended to alert compensation professionals about developments that may affect their companies. General questions may be addressed to David Cole in our New York office at 212.986.6330 or by email at dmcole@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.