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Re: Proposed Legislation Regarding Executive Deferred Compensation

Dear Clients and Other Friends:

The "Jobs and Growth Tax Relief Reconciliation Act of 2003" (H.R. 2) as approved by the Senate last week would make major changes to the tax rules governing executive deferred compensation. While there have been published reports that the deferred compensation changes and the rest of the Senate's revenue raising measures will be dropped, a member of the Senate Finance Committee's staff told us this afternoon that the deferred compensation changes are still on the table. As a result, it is possible that some version of the Senate's changes will emerge from the conference committee and become law. (The version of the bill approved by the House of Representatives did not address deferred compensation.)

If the final version of the legislation incorporates the Senate provisions, it will require substantial changes to most deferred compensation plans and to many individual executive deferral arrangements. Substantial changes from current common practices include:

- Deferred compensation would only be payable upon separation from service, death, disability, or at a specified time or pursuant to a fixed schedule. This provision would appear to prohibit "haircut" provisions, i.e., provisions that allow a participant to withdraw part of their deferred compensation account balance subject to a penalty, typically 10% of the amount withdrawn. (Such provisions seem to be a real hot button in Washington because they were used by Enron executives to liberate over \$53 million from the company treasury shortly before Enron filed for bankruptcy.) It is unclear what, if any, effect this provision would have on post-deferral distribution elections, since the statute does not say when the "specified time" must be specified. A prior version of the legislation included language that explicitly authorized second elections but that language was removed from the Senate bill before passage.
- Distribution could not be accelerated on account of any event. This provision would appear to prohibit accelerated payment due to financial hardship or a change in control of the employer.

- If a plan allowed a participant to choose among investment options, it would have to offer the same options as are available under whichever qualified plan of the employer has the fewest investment options. If this language were interpreted to require the identical menu of options, no more and no less, it would substantially restrict the choice of investment options.
- Amounts set aside to pay deferred compensation would have to be accessible to creditors at all times, not just after bankruptcy or insolvency, and while set aside could not be restricted to the provision of benefits under the plan. Apparently, the employer would have to be free to use the assets for other purposes. These provisions would eliminate most of the value of rabbi trusts as a payment security device.
- Any agreed-upon modification of a plan that accelerated the time of payment of deferred compensation would trigger immediate taxation of all amounts previously deferred, plus interest from the time when there first was no substantial risk of forfeiture. As it may be difficult to show that a participant did not “agree” to a plan amendment or other change, this could significantly limit the ability of employers to amend their plans.

The Senate bill would also prohibit nonqualified stock option plans from permitting participants to defer tax on option exercise proceeds by deferring receipt of the shares. Under the Senate bill, the exercise proceeds would be taxable at the time of exercise regardless of whether the employee elected to defer them.

As currently proposed, the above changes would only apply to compensation deferred after December 31, 2003.

These changes also would apply only to deferred compensation of public company executives subject to the Section 16 insider reporting requirements and to non-public company executives who would be subject to Section 16 if the company were public. The new rules do not apply to employees eligible for deferred compensation who are not at the Section 16 reporting level.

The proposed legislation does not appear to alter the rules regarding what is needed for an effective deferral election. The severe post-deferral restrictions imposed by the Senate bill, however, and the current atmosphere of hostility to executive plans generally, raise some concern about whether standards for an effective deferral election may yet be changed. For example, will it continue to be permissible to allow deferral elections to be made after the compensation amount is partially earned (as often occurs in connection with annual bonus or long-term incentive plans)?

While the delayed effective date would protect existing deferrals, the bottom line is that if this bill becomes law, many very common practices will have to change and executive deferred compensation plans will become much less flexible and useful.

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These rules may yet be dropped from the final legislation. But if you are concerned about the changes described above and want to preserve your current practices, this might be a good time to let your senator or congressman know (particularly if he or she is on the Conference Committee).

If you have questions concerning the legislation, or would like our help in preparing comments or in understanding how the legislative proposals will affect your programs, please let us know.

Sincerely,

John W. Haine