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MEMORANDUM

RE: New Deferred Compensation Legislation

DATE: October 12, 2004

The “American Jobs Creation Act of 2004” approved by the Senate on October 11, 2004, and by the House on October 7, 2004, rewrites the tax rules applicable to non-qualified deferred compensation plans. This law will necessitate major changes to most such plans. The new rules apply to compensation deferred after 2004, so it is important that employers promptly determine how their deferred compensation plans will be affected.

The deferred compensation portion of the legislation is in § 885 of the Act, which adds new § 409A to the Internal Revenue Code. The Conference Report comments on some issues which are not addressed explicitly in the Act and may be the subject of future regulations.

Background. Prior to this legislation, the Internal Revenue Code and IRS regulations did not contain detailed rules about deferred compensation. Regulations issued under Code § 451 offered the general principle that compensation would be taxable when it was “actually or constructively received by the taxpayer”. In a few litigated cases, the IRS asserted that the taxpayers’ attempts to defer compensation were ineffective because they already had “constructively received” the compensation, but the IRS generally lost those cases. In the 1970s, the IRS attempted to issue regulations prohibiting most forms of deferred compensation, but Congress blocked that effort in 1978. In the absence of supportive court decisions or regulations, the main IRS authority on this subject was the IRS ruling position, originally announced in 1971 and reaffirmed in 1992, that the IRS would not issue a favorable ruling on a deferred compensation arrangement unless it required deferral elections to be made before the beginning of the tax year in which the deferred compensation was earned and prohibited most later elections to change the payment date. In light of the lack of authority supporting the IRS ruling position, employers largely dealt with it by not requesting rulings on deferred compensation issues. The absence of clear guidelines on how to handle deferred compensation elections led to certain less restrictive practices becoming widely accepted by employers and their advisers.

In place of this rather flexible deferred compensation environment which has existed for many years, the new legislation imposes detailed rules about the election procedures a deferred compensation plan must follow in order to effectively defer tax, and substantial tax penalties on deferred compensation that fails to follow the new rules.

What types of compensation does the new law apply to? It applies to any plan, agreement or arrangement that provides for deferral of compensation, including arrangements applicable to only a single person and arrangements with non-employees, such as directors and independent contractors.

Arrangements subject to the new rules include:

- Plans allowing an employee to defer payment of part or all of salary or bonus until a later tax year.
- Long-term incentive plans that give participants flexibility in choosing a payment date.
- Individual employment contracts that provide for deferred pay.
- Stock appreciation rights structured so that an employee can choose when to exercise the right. (The Conference Report does note that issues relating to SARs – which were the subject of considerable lobbying prior to passage – may be addressed in regulations.)
- Non-qualified supplemental retirement plans (SERPs).
- Restricted stock units/phantom stock.
- Stock options and restricted stock that give participants an opportunity to defer taxation beyond exercise or vesting.
- Discounted stock options where the exercise price is less than the fair market value on the date of grant. (The discount element is viewed as a form of deferred compensation.)
- Plans allowing outside directors to defer receipt of their director fees.

For additional examples of practices that may be affected by the new law, see the list at the end of this memorandum.

The new law does not apply to qualified pension, 401(k) or profit sharing plans, ESOPs, tax sheltered annuities, or Code § 457(b) plans of non-profits or government employers. It also does not apply to vacation pay or sick pay that can be carried over from one year to the next or to disability or death benefit plans. (There is no statutory exception for severance pay, however.) Incentive stock options and options granted under a Code § 423 employee stock purchase plan are not affected. Non-qualified stock options also will not be affected if the exercise price is not less than the fair market value of the stock on the date of grant and the option holder is not permitted to defer payment of the exercise proceeds beyond the exercise date.

What the new law requires. The requirements fall into three main categories: (1) new deadlines for making deferral elections, (2) restrictions on the deferred payment date, and (3) a ban on accelerating payment.

- (1) **Deferral elections.** In general, any election to defer compensation must be made before the beginning of the earliest year in which the compensation is earned.¹ For example, an election to defer salary earned in 2005 would have to be made by December 31, 2004.

For new participants, the election deadline is 30 days after the date the individual first was eligible to participate. For example, an individual hired May 1, 2005 could make a 2005 salary deferral election by May 31, 2005, rather than being subject to the December 31, 2004 deadline applicable to other participants.

For compensation earned over a multi-year period, such as a long-term bonus or long-term incentive pay, the election generally must be made before the beginning of the period the bonus or incentive pay is earned.

If bonus or incentive pay is “performance-based”, the new law allows the deferral election to be made not later than six months before the end of the period in which the bonus is earned. The Conference Report says that, to be performance-based, pay must be “(1) variable and contingent on the satisfaction of pre-established organizational or individual performance criteria and (2) not readily ascertainable at the time of the [deferral] election.” The Conference Report anticipates there will be regulations defining which types of pay are considered performance-based and that the definition will not be exactly the same as the performance pay definition used under Code § 162(m) to determine whether public company executive pay in excess of \$1 million per year is deductible by the employer.

In addition to the initial deferral election described above, the new law also allows participants to make later elections delaying the payment date. Any such election must be made at least 12 months before the scheduled payment date. If made, the later election must result in the first affected payment being deferred to a date at least five years after its original scheduled payment date. (This five year requirement is waived if the participant later dies or becomes disabled, or if the employer has a change in control.) The Senate version of the legislation limited participants to one subsequent election, but that limit was dropped from the final bill.

- (2) **Payment date.** The plan (or participant election made pursuant to the plan) must provide that the deferred compensation will be paid not earlier than one or more of the following events:

- Participant’s separation from service, subject to a requirement that distributions to certain executives of public companies not be paid until at least six months after the individual’s separation from service. The six-month delay applies to any executive who is a “key employee” within the meaning of Code §416(i) (a group that includes 5% owners, some owners of 1% or more, and as many as 50 officers making at least \$130,000, adjusted for inflation).

¹ It is not clear how to apply this deadline if the employer has a different tax year than the employee. The Conference Report anticipates there will be regulations dealing with such cases.

- Participant becomes disabled².
- Participant's death.
- Payment date or payment schedule elected by the participant or specified in the plan at the time of deferral.
- Change in control of the employer.
- Occurrence of an unforeseeable emergency, such as uninsured medical expenses or casualty loss that cannot be met from participant's other resources.

The election rules are particularly troublesome for plans such as SERPs, which have no initial deferral election and have typically allowed participants to choose the form of payment at or near the time of retirement, either directly in a separate SERP election or indirectly because the SERP benefits are automatically paid in the same form as the participant elects under a tax-qualified plan. The Conference Report indicates that regulations may deal specifically with the SERP distribution timing problem.

- (3) **Payments may not be accelerated.** Payment terms established at the time of the deferral may not be modified later to accelerate payment. For example, if the participant elects that the deferred compensation will be paid in ten annual installments beginning the year the participant attains age 65, the participant and employer may not elect later to accelerate the payments to a lump sum at age 60. It doesn't matter whether the acceleration was initiated by the employer or the employee. Another example of a violation of this requirement would be a "haircut" provision whereby participants can access their deferred compensation account at any time subject to a financial penalty. The Conference Report anticipates some regulatory exceptions such as for tax withholding and in the event of divorce. It also suggests that regulations will not treat a plan as violating the prohibition on acceleration if it establishes a minimum amount below which benefits will automatically be cashed out (e.g., account balances below \$10,000).

Effective date. The new law applies to compensation deferred on or after January 1, 2005. Amounts deferred before 2005, and subsequent earnings on such amounts, are not subject to the new law, provided the plan under which these amounts were deferred is not materially modified after October 3, 2004. The Conference Report indicates that amounts will be considered deferred before January 1, 2005 if they are "earned and vested" before that date. There are a number of uncertainties about how certain pay arrangements will transition to the new rules (e.g. long-term incentive awards or restricted stock units granted before 2005 but

² "Disability" is defined as either (i) unable to engage in any substantial gainful activity for period expected to last 12 months or (ii) receiving income replacement benefits for at least 3 months under employer's accident and health plan due to a condition expected to last at least 12 months.

payable in 2005 or later). The legislation history directs the IRS to promptly develop regulations addressing these issues.

Penalty for non-compliance. If a plan violates any of the requirements of the new legislation, affected individuals will be subject to these taxes for the year of violation:

- Regular federal income tax on the deferred compensation.
- An additional tax equal to 20% of the deferred compensation amount.
- A second additional tax equal to interest that would have been payable if the tax liability on the deferred compensation was incurred when the compensation first became vested. This interest is calculated at the regular federal rate for underpayments, plus one percentage point.

Note that these tax burdens fall on the participant, not on the employer. One can easily imagine situations where the aggregate tax amount on a participant would exceed his or her deferred compensation balance.

New IRS reporting requirements. The new law requires employers to show deferred compensation amounts on each employee's W-2 form (or on 1099-MISC for a former employee or independent contractor) regardless of whether the deferred compensation is currently taxable. This new reporting requirement is intended to give the IRS a way to monitor deferred compensation programs, select audit targets, and enforce the new rules. The first reporting will be required for 2005 W-2s distributed early in 2006. The law authorizes the IRS to set a minimum amount of deferrals below which the reporting requirement will not apply. Also, for non-account balance plans such as SERPs where the amount accrued is not reasonably ascertainable, the Conference Report says the regulations may delay the reporting requirement until the amount becomes reasonably ascertainable.

Other issues. The new law also imposes adverse tax treatment on deferred compensation funded through a trust established outside the United States. There is a limited exception if the trust is for the benefit of employees whose work sites are in a location where the trust is held. Also, there is adverse tax treatment for trusts that are funded in response to the employer's financial distress.

No restriction on investment choices. The Senate version of this law prohibited non-qualified deferred compensation plans from offering investment options that were not available under the employer's qualified plan that offered the fewest investment choices. That requirement was deleted from the final legislation.

**Common Deferred Compensation Practices
Affected by the American Jobs Creation Act of 2004**

- Bonus deferral elections made near the end of the period the bonus is earned.
- Elections made in 2004 to defer 2004 bonus otherwise payable in 2005.
- Mid-year salary deferral elections
- Running deferred compensation plan on employer's fiscal year rather than employee's tax year.
- "Haircut" provisions allowing employees to withdraw deferred compensation early, subject to a penalty equal to percent of amount withdrawn.
- Hardship withdrawals.
- Allowing employees to withdraw deferred compensation before scheduled payment date subject to employer's consent.
- Elections to defer proceeds upon stock option exercise.
- Stock appreciation rights.
- Elections to defer receipt of restricted stock units.
- SERP distribution elections.
- Second elections to extend period of deferral.
- Accelerated payments upon plan termination
- Modifying an acquired company's deferred compensation plans to simplify payment options.
- Accelerating payment upon change of control.
- Paying top executives of a public company promptly after they terminate employment.
- Accelerating payment if employee becomes disabled.
- Deferrals imposed by the employer (perhaps due to employer's financial distress) where ultimate payment date is uncertain.
- Discounted stock options.
- Rabbi trust contributions triggered by employer's financial distress.