

Client Alert

A report
for clients
and friends
of the firm October 2004

Recent Legislation Impacts Deferred Compensation and More

In response to the perceived abuse of nonqualified deferred compensation arrangements for the benefit of executives, Congress recently passed the American Jobs Creation Act of 2004 (the "Jobs Act"), which will have a substantial impact on these arrangements.

The Jobs Act adds new Section 409A to the Internal Revenue Code of 1986, as amended (the "Code"), which codifies Internal Revenue Service ("IRS") "best practice" positions and significantly alters the rules applicable to nonqualified deferred compensation. The new rules will impact the manner in which these arrangements are designed and administered and will also cover many other arrangements typically not considered "deferred compensation" (including equity plans) because the new rules broadly define what is considered to be a "nonqualified deferred compensation plan."

The new rules are broad and, in certain instances, ambiguous. Many of the provisions of Code Section 409A specifically provide that the provisions are subject to guidance to be issued by the IRS. While this guidance will be issued shortly, it is expected that steps should be taken immediately to assure compliance with the new rules. The following is a summary of the key requirements of the Jobs Act applicable to nonqualified deferred compensation arrangements.

Effective Date

When signed by the President, the provisions of the Jobs Act will apply to amounts deferred after December 31, 2004. Amounts earned and vested on or before December 31, 2004 are grandfathered under

the current rules (*i.e.*, they are not subject to the new rules), provided that no material modifications have been made to the arrangement after October 3, 2004.¹ Earnings on amounts deferred before the effective date are subject to the Jobs Act only to the extent that the deferred amounts are subject to the new rules. Thus, unvested amounts under an arrangement that has been in existence prior to December 31, 2004, will need to be modified to comply with the new rules. This may raise contractual and accounting issues.

Within 60 days after the enactment of the Jobs Act, the IRS will issue guidance providing a limited transition period during which employers will be permitted to amend nonqualified deferred compensation arrangements adopted before December 31, 2004, to permit participants to terminate participation or cancel an outstanding election or to conform such arrangements to the new rules.

Arrangements Subject to the New Rules

The definition of nonqualified deferred compensation is extremely broad and, as written, includes a variety of arrangements that currently are not subject to the rules applicable to deferred compensation. A nonqualified deferred compensation arrangement will include any plan, agreement or arrangement, including an agreement or arrangement that includes one person, that provides for the deferral of compensation, other than: (i) a qualified employer plan (*e.g.*, a 401(k), ESOP, profit sharing, 403(b) or 457(b) plan); or (ii) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. The Conference Report provides that the provisions are not intended to apply to: (1) annual bonuses or other annual compensation amounts paid within two and one-half months after the close of the taxable year in which the relevant services required for the payment were performed; or (2) stock option arrangements taxable under Section 83 of the Code with an exercise price that is equal to or greater than the fair market value of the underlying stock that do not contain deferral features, other than the feature that the option holder has the right to exercise the

option in the future. Accordingly, while Code Section 409A does not specifically address equity, pursuant to the Conference Report, any arrangement that permits a participant to defer any gains realized as a result of the exercise of a stock option, or utilizes discount options or provides for the grant of stock appreciation rights, is subject to the new rules. Restricted stock, restricted stock units and other forms of equity are not specifically addressed in Code Section 409A or the Conference Report, but it appears that they are considered deferred compensation based on the broad scope of the new rules.

Requirements to Avoid Taxation in the Year of Deferral

If at any time during a taxable year a nonqualified deferred compensation arrangement does not comply with Section 409A, all compensation deferred under the arrangement for the taxable year *and all preceding taxable years* is taxable for that year unless the compensation is subject to a substantial risk of forfeiture or has been previously included in a participant's gross income.² The adverse tax consequences (plus the additional consequences described below), however, only apply with respect to compensation deferred under the arrangement for participants with respect to whom the failure to comply relates. The key requirements for deferred compensation that is not subject to a substantial risk of forfeiture to avoid taxation in the year of deferral are:

Permissible Distributions

- Deferred compensation cannot be distributed prior to: (i) a participant's separation from service (subject to a six-month delay for certain "key employees" as defined in Section 416(i) of the Code³); (ii) a participant's disability⁴ or death; (iii) a specified time or under a fixed schedule specified under the arrangement as of the date of deferral;⁵ (iv) a change in control (to the extent provided by the IRS);⁶ or (v) the occurrence of an unforeseeable emergency.⁷
- Non-employee directors are not considered "key employees" and the six-month delay does not apply to privately held companies.

Prohibition on Acceleration of Distributions

- The arrangement cannot permit the acceleration of the time or schedule of any payment, except as provided in regulations to be promulgated by the IRS.

Requirements with Respect to Initial Elections

- A participant's initial deferral election must be made in the calendar year prior to the year in which the

compensation is earned, unless otherwise provided in regulations (or within 30 days after the participant becomes eligible to participate in the arrangement); and

- the time and form of distributions must be specified at the time of the initial deferral.

However, in the case of any performance-based compensation based on services performed over a period of at least 12 months, the election to defer may be made no later than six months before the end of the service period. It is intended that performance-based compensation may be required to meet certain requirements similar to those under Code Section 162(m). This is likely to mean discretionary plans will not qualify for the six-month rule.

Requirements with Respect to Subsequent Elections

- A participant's subsequent election to further defer payment or change the form of payment must not be effective for at least 12 months after the date on which the election is made;
- payment under a subsequent election may not be made for at least five years from the date the original payment would have otherwise been made, except in the event of elections relating to distributions on account of death, disability or an unforeseeable emergency; and
- an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment.

Accordingly, election changes with respect to the payment date or form will occur much less frequently.

Additional Taxation

If the new rules are not satisfied, in addition to current income inclusion, interest at the underpayment rate (currently 5%) plus 1% is imposed on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20% additional tax.

Offshore Rabbi Trusts and Other Relevant Provisions of the Jobs Act

The Jobs Act further provides that amounts deferred under an arrangement that provides for assets to be held in an offshore trust or similar arrangement (as determined by the IRS) will be treated as property transferred under Section 83 of the Code and, therefore, will be included in an

individual's gross income whether or not such assets are available to satisfy claims of general creditors.

Many employers currently fund their nonqualified deferred compensation obligations through "rabbi trusts." Rabbi trusts are typically irrevocable and generally do not permit trust assets to be used for any purpose other than to provide nonqualified deferred compensation benefits. However, the provisions of the trust document provide that trust assets are subject to the claims of the employer's creditors. Congress has noted that many employers establish rabbi trusts in foreign jurisdictions in which practical access to the trust assets in the event of the employer's insolvency is limited or nonexistent.

The Jobs Act effectively precludes the use of offshore rabbi trusts for U.S. nonqualified deferred compensation arrangements. Each transfer of assets to such trust and any earnings thereon would be taxed currently to the participants. The Jobs Act provides an exception to this rule with respect to employees who perform substantially all of their services in the foreign jurisdiction in which the trust is located. In addition, the Jobs Act gives the IRS the authority to exempt arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being beyond the reach of creditors.

The Jobs Act further provides that amounts deferred under a nonqualified deferred compensation arrangement (and any earnings thereon) that provides that, upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation (whether or not such assets are available to satisfy the claims of general creditors) will be treated as property transferred under Section 83 of the Code and, therefore, will be included in an individual's gross income.

Failure to follow the rules applicable to offshore trusts and an employer's financial health will subject an individual to the same interest and penalties as described above.

The Jobs Act requires employee deferrals under a nonqualified deferred compensation arrangement to be reported on Form W-2 (or Form 1099 for independent contractors), even if the amount is not currently includible in income for that taxable year. The IRS is permitted to exempt employee deferrals that fall below a de minimis amount from such reporting requirements.

Next Steps

Since the Jobs Act significantly impacts the design and administration of nonqualified deferred compensation arrangements, employers should review their nonqualified

deferred compensation arrangements and equity plan grants to ensure compliance with the rules. Arrangements that do not comply will need to be amended in order to avoid constructive receipt and other adverse tax consequences. Alternatively, some employers may choose to freeze their existing nonqualified deferred compensation arrangements and start new arrangements altogether. Hopefully, more insight will be obtained when the IRS issues its guidance. In the interim, employers must focus on year-end deferral elections, existing unvested arrangements, pending equity grants and should identify all arrangements that are subject to the new rules and analyze these arrangements to determine the impact of the new rules as soon as possible. Employers will also have to be concerned, as noted above, as to how to assure compliance with plan contractual limitations on amendments and the accounting impact of any change in existing equity grants.

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- ¹ The Conference Report provides that the addition of any benefit, right or feature to a nonqualified deferred compensation arrangement or the acceleration of the arrangement's vesting provisions will be considered a material modification. The exercise or reduction of an existing benefit, right or feature, a change in the plan administrator or an amendment to remove a distribution period would not be considered material modifications.
 - ² The Jobs Act provides that the IRS may issue regulations to disregard substantial risks of forfeiture in cases where necessary to carry out the purposes of the legislation.
 - ³ Generally, the top 50 officers with annual compensation from the employer of over \$130,000, a 5% owner of the employer or 1% owner with annual compensation from the employer of over \$150,000.
 - ⁴ A participant is considered to be disabled if the participant: (i) is unable to engage in any substantial gainful activity due to physical or mental impairment which can be expected to result in death or to last for a continuous period of 12 months or more, or (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan sponsored by his employer.
 - ⁵ Amounts payable upon the occurrence of an event, such as a child beginning college, are not treated as amounts payable at a specified time.
 - ⁶ The IRS is expected to issue guidance as to what constitutes a change in control, which is likely to be based on, but more restrictive than, Code Section 280G.
 - ⁷ An "unforeseeable emergency" means a severe financial hardship to a participant resulting from an illness or accident of the participant (or his or her spouse or dependent), loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

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