SEYFARTH SHAW
MANAGEMENT ALERT

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Deferred Compensation: Make Changes or Pay Taxes Under New Act

Congress has passed legislation that will substantially affect all nonqualified deferred compensation plans and employment agreements that include deferral arrangements, and may also affect other forms of compensation. The new legislation, included in the American Jobs Creation Act of 2004 ("Act"), amends the Internal Revenue Code and will take effect January 1, 2005. Employers need to begin immediately reviewing their deferred compensation plans and agreements, if possible before employees make deferral elections for 2005.

Under the Act, all deferred compensation plans and arrangements must contain certain specified restrictions on elections and distributions, and must be operated in accordance with those restrictions to avoid adverse taxation. Failure to comply will cause all deferred compensation under the plan to be taxed, for the affected individual, when it is earned (or vested, if later) at a rate equal to normal income tax rates plus an additional 20% penalty tax. In addition, the individual's compensation previously deferred under the same plan would be retroactively taxed, including the imposition of interest for underpayments resulting from not taxing the compensation when deferred.

Traditional Deferred Compensation - and More

The Act applies to nonqualified deferred compensation arrangements, including elective deferral plans, such as "wrap" 401(k) plans and bonus deferral plans, and also supplemental executive retirement plans (SERPs) and excess benefit plans. A plan or agreement covering only one person will be covered, so employment agreements with a compensation deferral or severance feature should be reviewed for compliance. Deferral arrangements maintained by tax-exempt and governmental plans, other than qualifying plans under Code §457(b), are also covered. The Act also applies to plans for non-employees, such as plans allowing outside directors to defer their fees, or to consulting agreements with compensation deferral features.

Based on informal comments, the IRS appears to be taking a broad view of what constitutes "deferred compensation." It appears that the Act may apply to severance plans, stock appreciation rights and phantom stock (although stock options granted at fair market value are not covered), and even paid time off ("PTO") plans if the employee has the right to cash out a portion of an accumulated PTO account.

The Act provides limits on (1) when compensation deferral elections can be made, (2) when benefits can be distributed, and (3) certain types of funding mechanisms.

Deferral Elections - Changed Rules

The basic limitation on deferral elections is that a participant must make any deferral election prior to the beginning of the calendar year in which the compensation is deferred. This applies to deferrals of base compensation, and any form of incentive compensation that does not qualify for the six-month rule described below. Once made, this election cannot be changed during the year, including for 401(k) supplemental plans. Employees should be advised of the new limitations before making deferral elections for 2005. While regulations under the Act may relax the general rule for specific situations, the regulations may not be issued in time for employers to incorporate the guidance into the election process conducted in the fourth quarter of 2004.

Deferrals of incentive compensation — both annual bonuses and long-term incentive plans — may qualify for a special rule. Under this rule, if the incentive compensation is paid under a performance-based plan that covers at least a 12-month measurement period, the deferral election can be made up to six months before the end of the measurement period. This would mean, for example, that an employee could elect to defer his or her 2005 annual bonus (payable in 2006) up until June 30, 2005. However, in order to qualify, the bonus plan must be based on objective performance factors put into place no later than the first quarter of the measurement period. Regulations are anticipated to borrow from, but not be as strict as, Code §162(m) performance measure provisions. A guaranteed bonus is not eligible for the six-month rule, and is treated the same as base compensation.

Whether a bonus earned in 2004 and payable in 2005 is subject to this new rule will depend on whether the bonus is

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vested on December 31, 2004. A bonus that vests on or before December 31, 2004 will be subject to current law, even if the amount of the bonus is not finally determined and paid until 2005. If the bonus arrangement provides that employees who terminate after December 31, 2004 but before payment forfeit their bonus, the bonus is not vested on December 31, 2004 and is subject to the new Act. This would mean that the deferral election should have been made by June 30, 2004 for performance-based bonuses and by December 31, 2003 for others. However, the IRS has informally indicated that the transition regulations may allow exceptions for 2004 elections.

The legislative history indicates that a normal annual bonus payable within 2-1/2 months after the end of the year, with no further deferral, is not considered to be deferred compensation subject to the Act.

Limits on Distributions and Funding

Under the Act, there are a number of limits on the time at which benefits can be distributed, which will require substantial revisions to many plans. Employees will be required to elect a method of distribution at the time of deferral or rely on mandatory provisions in the plan. Distributions will be limited to specific occasions: death, disability, separation from service, unforeseen financial emergency, change in control or a specific time (not event). Different distribution elections may apply to different distribution events. Other limitations relate to:

- No *acceleration* of benefit payments is permitted, with certain limited exceptions. Common plan provisions, such as "haircut" clauses allowing an employee to make a withdrawal upon payment of a 10% penalty, or premature distribution at the election of the employer, are not permitted. Also, a participant who has elected annuity installments under a supplemental retirement plan, for example, may not be able to change the distribution method to a lump sum or shorter installment method.
- *Hardship withdrawals* continue to be permitted, but under the more stringent "financial emergency" standard that has always applied to nonqualified plans, rather than the more lenient 401(k) plan standard.
- Although a "*change in control*" may trigger a distribution, the definition of change in control must be consistent with IRS regulations yet to be issued.
- Distributions to a "*key employee*" of a public company upon a termination of employment cannot be made until six months after the termination, with exceptions for death and disability. Key employees (as defined in Code §416) are generally the fifty most highly compensated officers, and certain shareholders. The potential application of this rule to severance as well as deferred compensation is one of the more troubling aspects of the new law.
- Any elective *change to the time or form of payment* that is made after the initial deferral election must result in an additional deferral of at least five years (beyond the original date that payments would otherwise have begun), and the change must be elected at least twelve months before the distribution would otherwise have been made. Distributions tied to election of a form of payment under a qualified plan may be significantly curtailed.

As an example, an employee could elect a lump sum to be paid upon attainment of age 55 while still employed and 5 year installments on any termination of employment (different elections for different events). No later than age 54 (one year before payment), the employee changes the election to a lump sum at attainment of age 60 (5 year additional deferral). At age 57, the employee terminates employment and is paid installments over 5 years (termination event occurs first).

Limits on Funding

In addition to the restrictions on deferral elections and distributions, the Act prohibits the use of offshore and certain "springing" rabbi trusts. A springing rabbi trust is one that is not funded until a specified event occurs. Under the new law, the funding of a rabbi trust cannot be triggered by a decline in the company's financial health. Not only can the plan not require funding in this case, but the tax penalties may also apply if the company in fact begins funding a rabbi trust when it is in financial difficulty. A rabbi trust that is funded on a change in control is permitted, as long as the funding is not also triggered by the company's financial condition. Offshore rabbi trusts are now completely prohibited.

What Must Be Done Now?

Employers should promptly notify employees (and directors, if applicable) who are now making deferral elections for 2005 of the potential changes to their deferred compensation arrangements. This is particularly important if the plan currently allows participants to change their deferral elections during the year, or to make in-service withdrawals. New election forms may be needed. Employers also need to review all deferred compensation plans and arrangements, as well as individual employment agreements that provide for deferral, for compliance with the Act.

Some points to keep in mind are:

- **Grandfather rules**. The Act applies only to amounts deferred (earned and vested) after December 31, 2004. Accordingly, amounts deferred and vested prior to that date may continue to include in-service withdrawal rights and other provisions that were permitted under prior law. However, if a pre-2005 plan is materially modified after October 3, 2004, the pre-2005 deferrals also become subject to the new law. Employers will need to decide whether to freeze the old plan and start a new one, to maintain both old law and new law deferrals in the same plan, or to simply apply the new law to all deferrals for administrative simplicity. Amendments to vest before 2005 may be material modifications.

- **Additional Guidance**. The IRS is required to issue transitional regulations, expected by year end, that will permit employees who find the Act to be too restrictive to revoke prior deferral elections without tax penalties. Accordingly, if there is a question as to the effect of a particular deferral election, in general it is better to make the election now and rely on the transitional regulations to revoke it later, if necessary.
- **Document Changes**. Amendments to plan documents generally do not have to be made by December 31, 2004. The IRS has indicated that it will provide a transitional period for making document changes, although in all likelihood the company will need to begin operating in conformance with the new law on January 1, 2005. However, appropriate employee communications will push employers to make key design change decisions sooner rather than later.
- **Negotiated Agreements**. It cannot be too strongly emphasized that the Act applies to all deferred compensation arrangements, including individual employment agreements. While the employer will generally be able to unilaterally revise its deferred compensation plans, changes to employment agreements will need to be negotiated.

If you have any questions concerning the Act and any deferred compensation plans or arrangements, please contact the Seyfarth Shaw LLP Employee Benefits Group attorney with whom you work or any Employee Benefits attorney on the website at www.seyfarth.com.

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