Advisory

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Employee Benefits

Congress Limits Deferred Compensation Plans Effective January 1, 2005

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On October 11, the Senate approved the American Jobs Creation Act of 2004, H.R. 4520 (which was approved by the House of Representatives on October 7). It is expected that President Bush will sign the bill. Once enacted, the American Jobs Creation Act (the "Act") will impose a new 20% excise tax penalty on executives' benefits under non-qualified deferred compensation plans, if the plans fail to satisfy new restrictions effective January 1, 2005.

A "non-qualified deferred compensation plan" under the Act can be an employee plan (other than a qualified plan) or an individual arrangement, including 457(f) plans of tax-exempt organizations or governmental entities. The Act also treats various forms of equity compensation as "deferred compensation plans," such as *discounted stock option awards, stock appreciation rights (SARs), and restricted stock units.*

All companies that sponsor non-qualified plans and equity plans should immediately review and, if necessary, amend their plans and agreements so that they satisfy the new restrictions. If plans are not amended, deferrals after December 31, 2004 may be immediately taxable to executives, and the executives may also incur a 20% penalty tax. There will be a limited grace period in which companies will be permitted to amend existing plans to deal with deferrals after 2004. (The Act directs the Treasury Department to issue regulations within 60 days establishing this grace period.)

Here is a brief summary of provisions that trigger immediate taxation.

TRIGGER EVENTS:

Electing the time and form of payment: generally, these elections must be made at the time of initial deferral. Elections to accelerate payments of deferred compensation are generally prohibited.	Examples: electing to be paid a reduced amount (a 10% "haircut") in order to accelerate payment. Electing to be paid immediately if there is an event signaling the employer's financial insolvency. Changing an existing installment payment election to a lump-sum payment election.
Elections to delay payment of benefits: these are permitted ONLY if they take effect at least 12 months after the election is made.	Examples: Changing an existing lump sum payment election to an election to be paid in installments. This election would not trigger tax if the executive made the election at least 12 months before the lump sum were otherwise payable. However, if the executive waited until one month before the payment date to make the election, he or she would be taxed on the full amount on the payment date.
Payments triggered upon disability or separation from service: these are still permitted.	A mandatory definition of "disability" is included in the Act. Also, top officers in public companies cannot receive distributions until at least 6 months after their separation from service.

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Elections to defer annual BONUSES: these are permitted, but only if the election is made prior to the year in which any related services are performed. If the bonus is a performance-based bonus (meeting rules similar to the rules for Section 162(m) performance-based compensation), then the deferral election must be made at least 6 months before the end of the year for which the bonus is earned.	***Important note: to defer bonuses earned during 2005, executives will be required to elect no later than December 31, 2004.*** ***Bonuses earned for 2004, if payable in 2005, will be subject to the new rules if they are not fully vested at year-end 2004.***
Elections to delay a fixed payment date: these are permitted, but only if the deferral is at least 5 years from the original fixed payment date, and the election is made more than 12 months before the first scheduled payment date.	Example: Benefits are to be paid at age 55 (a fixed date). The executive may elect at age 54 or earlier to defer the payment date until age 60 or later.
Rabbi trusts are permitted, but with new restrictions:	Offshore rabbi trusts are immediately taxable. A rabbi trust that "converts" to a non-rabbi trust (ie., a secular trust) upon a decline in the employer's financial health will be immediately taxable. (This rule applies if the trust contains the provision, not if the provision is triggered.)
Hardship distributions: Plans may still provide for in-service withdrawals by executives triggered by "unforeseeable emergencies."	Generally, an "unforeseeable emergency" must involve a hardship arising from illness, accident, casualty loss or other unforeseeable circumstances. The definition is more restrictive than hardship withdrawals in 401(k) plans.

"Grandfathering" existing deferred compensation arrangements: If an existing deferred compensation benefit is earned ***and vested*** as of December 31, 2004, it will not be subject to these rules, so long as there is no "material modification" to the plan after October 3, 2004. (Also, earnings credited on that grandfathered balance are not subject to the new rules.) For example, if a deferred compensation plan were amended to add an additional benefit, such as an installment payment option, then the plan would lose its "grandfathered" status for pre-2005 deferrals.

We encourage you to contact a member of our Employee Benefits Practice Group to review your company's deferred compensation arrangements in light of this new law.

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