

Client Alert

Sweeping Changes to Law Governing Nonqualified Deferred Compensation Plans

New corporate tax legislation, known as the American Jobs Creation Act of 2004 (the "Act"), will make sweeping changes to the law governing nonqualified deferred compensation plans. The House of Representatives passed the legislation on October 7, 2004 and the Senate passed the legislation on October 11, 2004. The President is expected to sign the legislation into law shortly.

Overview

Once enacted, the legislation will drastically change the way nonqualified deferred compensation plans are designed and operated. The legislation:

- covers a wide range of deferred compensation arrangements, including traditional deferred compensation plans, certain equity-based plans and employment, severance and change of control agreements;
- covers a wide range of entities (businesses of all forms and size) and individuals (employees, directors and consultants);
- imposes new and strict requirements for deferred compensation elections, distributions, accelerations of benefits and funding;
- imposes a six month waiting period before distributions may be made to certain "key employees" following separation from service;
- effectively eliminates the use of "haircuts" (where a participant agrees to forfeit a portion of his or her benefit in exchange for an earlier payment of benefits);
- restricts the use of offshore trusts and "springing rabbi trusts" to fund deferred compensation obligations; and
- imposes severe tax consequences on participants under arrangements that do not meet the new requirements, including immediate taxation, an additional 20% penalty tax and interest at the federal underpayment rate plus one percent.

The legislation is generally effective for (1) amounts deferred after December 31, 2004 and (2) amounts deferred before January 1, 2005 under plans that are materially modified after October 3, 2004. As a result, companies should act promptly to ensure that future deferred compensation will comply with the new law. Companies should proceed cautiously when amending existing deferred compensation arrangements to avoid subjecting existing arrangements to the new requirements and adverse tax consequences.

Covered Nonqualified Deferred Compensation Plans

The Act defines a “nonqualified deferred compensation plan” as any plan that provides for the deferral of compensation other than a (1) qualified plan and (2) a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. The legislation applies to businesses of all forms (corporations, partnerships, S-corporations, LLCs, LLPs, sole proprietorships, for-profits, not-for-profits and governments) and size. The legislation covers any taxpayer (employees, directors and consultants) who defers compensation under any covered plan. The term “plan” applies to any arrangement or agreement covering one or more persons, including employment, severance and change in control agreements.

Covered Plans. The legislation covers a wide range of nonqualified deferred compensation, including for example:

- traditional nonqualified deferred compensation arrangements, such as elections to defer future pay and bonuses;
- supplemental executive retirement plans (“SERPs”), excess benefit plans and excess savings plans;
- ineligible tax-exempt and governmental deferred compensation plans (Internal Revenue Code (“Code”) Section 457(f) plans); and
- certain equity-based arrangements, including stock options granted at below-market value (discount options), phantom stock, restricted stock units and (arguably) stock appreciation rights (“SARs”) and membership appreciation rights (“MARs”) for partnerships.

Important Note: As of this date, it is unclear how certain arrangements such as SERPs and equity-based arrangements will be treated under the Act and, in particular, whether SARs and MARs will remain a viable form of deferred compensation. It is hoped that the Treasury will issue specific guidance on these issues.

Non-Covered Plans. The legislation does *not* cover:

- qualified retirement plans (such as 401(k) plans and traditional pension plans), qualified tax-deferred annuities, simplified employee pension and SIMPLE arrangements;
- eligible deferred compensation plans under Code Section 457(b);
- incentive stock options meeting the requirements of Code Section 422;
- nonqualified stock options granted at fair market value (with no deferral feature other than the right to exercise the option in the future);
- employee stock purchase plans under Code Section 423;
- annual bonuses and other annual compensation amounts paid within 2½ months after the close of the taxable year in which the relevant services have been performed; and
- vacation, sick leave, compensatory time, disability pay and death benefit plans.

Requirements for Covered Plans

The legislation requires that covered nonqualified deferred compensation plans meet the following requirements related to deferrals, distributions, acceleration of benefits and funding:

Deferral Requirements.

The plan must include the following limits on initial and subsequent deferral elections:

Initial Elections. With respect to initial elections to defer compensation payable for future periods:

- elections must generally be made no later than December 31st of the year immediately preceding the taxable year in which the compensation is earned;
- new plan participants may make elections with respect to unearned compensation within 30 days of first becoming eligible to participate;
- for performance-based deferred compensation based on services performed over at least 12 months, elections may be made no later than six months before the end of the performance period; and
- the election must specify the amount (or percentage) of the compensation deferred and the time and form of distribution.

Subsequent Elections. The plan may permit changes in the time and form of payment for previously deferred compensation *only if*:

- the election is not effective until at least 12 months after the date on which the election is made;
- except in cases of disability, death or unforeseeable emergency, the election provides a deferral period of not less than five years after the date the payment would otherwise have been made; and
- in the case of an election to defer an amount scheduled to be paid at a specified time, the election is made at least 12 months before the date of the first scheduled payment.

Distribution Requirements.

The plan may allow distributions only under the following circumstances:

- separation from service (as determined by the Treasury);
- death;
- disability (as defined in the Act);
- specified time or under a fixed schedule;
- change in control (to the extent provided by the Treasury); and
- unforeseeable emergency (as defined in the Act) - generally a severe financial hardship.

Important Note: Under the Act, distributions to “key employees” of public corporations must not be made earlier than six months after separation from service (or, if earlier, the date of death). “Key employees” generally include: (1) officers with annual compensation greater than \$130,000, as

indexed (limited to 50 employees); (2) more than 5% owners; and (3) more than 1% owners with annual compensation greater than \$150,000.

Acceleration of Benefits.

The plan may not permit the acceleration of benefits, except as permitted by the Treasury. This effectively eliminates the use of “haircuts” (where a participant agrees to receive a reduced benefit in exchange for an earlier distribution). The Treasury is expected to issue regulations describing exceptions in cases where circumstances are beyond the control of the participant, and the distribution is not elective (for example, federal conflict of interest requirements and court-approved divorce settlements).

Funding Limitations.

The legislation severely restricts the use of offshore trusts and “springing rabbi trusts.”

- *Offshore Trusts.* Assets set aside in a trust or other arrangement outside of the United States for purposes of paying benefits under the plan will constitute property transferred to the plan participant in connection with services rendered for purposes of Code Section 83, regardless of whether the assets are subject to claims of the employer’s creditors. This effectively restricts (or eliminates) the use of offshore trusts to fund nonqualified deferred compensation plan obligations. An exception exists for assets located in a foreign jurisdiction, if substantially all of the services to which the nonqualified deferred compensation relates are performed in such jurisdiction.
- *Employer’s Financial Health.* If the plan provides that assets will become restricted to the payment of benefits under the plan in the event of a change in the employer’s financial health, compensation deferred under the plan will constitute property subject to taxation under Code Section 83. This effectively limits the use of “springing rabbi trusts” which seek to protect plan participants from bankruptcy by funding the trust if the employer’s financial condition worsens.

Tax Consequences

Violation of Election, Distribution and No Acceleration of Benefits Requirements. If the nonqualified deferred compensation plan does not meet the election, distribution and no acceleration of benefits requirements:

- all compensation deferred under the plan for the taxable year and for each preceding taxable year (and earnings related to such deferrals) will be includible in the plan participant’s gross income for the current taxable year;
- a 20% penalty tax will apply to all amounts required to be included in the participant’s income; and
- interest will be charged at the federal underpayment rate plus one percent for all amounts previously deferred.

The tax consequences apply only to the participant to whom the violation relates. The requirement to include such amounts in income for the current taxable year does not apply to the extent that such amounts remain subject to a substantial risk of forfeiture or were taxed previously.

Violation of Funding Requirements. The tax consequences are similar for violations of the funding requirements:

- in the case of a prohibited offshore trust, the assets transferred to the offshore trust will be taxable at the time of transfer or, if later, the time when such amounts vest;
- in the case of a “springing rabbi trust”, all amounts deferred under the plan will be taxable at the time the plan first provides for such trust (even if the trust is not yet established);
- any increase in value and earnings on assets in the prohibited offshore trust or “springing rabbi trust” will be taxed in the year in which the increase occurs or the earnings accrue;
- a 20% penalty tax will apply to all amounts required to be included in income; and
- interest is charged at the federal underpayment rate plus one percent for all amounts previously deferred beginning with the year of deferral or, if later, the time when such amounts vest.

Reporting Requirements

Amounts deferred for periods after 2004 must be reflected on a participant’s Form W-2, even if they are not includible in income.

Effective Date

As noted above, once signed by the President, the legislation will be effective for amounts deferred after December 31, 2004. In addition, the legislation will be effective for amounts deferred before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. An amount is considered “deferred” before January 1, 2005 if it is earned and *vested* before that date. This means that, technically, unvested amounts for periods before January 1, 2005 will be subject to the Act.

The legislation directs the Secretary of the Treasury to issue guidance generally within 60 days after the date the legislation is signed into law. The guidance is intended to provide a limited window during which plans may be amended to comply with the new law and participants may cancel plan participation or an outstanding deferral election with respect to amounts earned after December 31, 2004. The Treasury has also been instructed to issue guidance on a number of open issues including, for example, (1) (within 90 days) what constitutes a change in control for purposes of distributions under the Act, (2) how supplemental defined benefit plans will be treated, (3) what exemptions will apply to non-abusive offshore trusts, (4) how “financial health” will be defined, and (5) when substantial risk of forfeiture will be disregarded. It is hoped that the guidance will also address the extent to which certain equity-based arrangements (such as discount stock options, phantom stock and SARs) will be subject to the Act.

Action Required

Given the broad reach and impending deadline of the new legislation, employers are urged to act quickly to:

1. Inventory each plan and arrangement that may be subject to the Act (see “Covered Nonqualified Deferred Compensation Plans” on page 2 for a list of plans – remember individual agreements and equity-based arrangements as well as traditional plans);
2. Inventory each outstanding *unvested* award agreement under each plan that may be subject to the Act (unvested awards are subject to the Act);
3. Review each plan, arrangement and award that may be subject to the Act to determine what changes (if any) are required to comply with the law;
4. Prepare and adopt amendments to current plans, arrangements and award agreements and prepare and adopt new plans and arrangements to comply with the law (allow time for committee, board and, where required, shareholder approval);
5. Implement procedures for allowing participants to terminate participation or cancel existing deferral elections with respect to amounts earned after 2004 (if desired);
6. Update S-8 prospectuses, plan summaries and tax disclosures for affected plans and arrangements;
7. Communicate the new rules and changes to participants and encourage participants to seek advice of qualified personal tax advisors; and
8. Before amending any existing plan or arrangement, carefully consider the impact of the modification on the grandfathering available to existing deferrals. Also, consider other implications of such modification, including whether shareholder approval is required.

We would be happy to work with you to evaluate your current plans and arrangements and to develop a program to comply with the new law.

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