

# Employee Benefit Plan Review

DECEMBER 2004

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# New Nonqualified Deferred Compensation Law: What to Do (and Not Do) Now

MARJORIE M. GLOVER AND SARAH C. RICHARDS

The American Jobs Creation Act of 2004 substantially changes the law governing nonqualified deferred compensation plans. The new law imposes strict new rules on deferred compensation elections, distributions, acceleration of benefits and funding, and imposes severe tax consequences if the new rules are violated. These rules and tax consequences are summarized in the chart in the Regulatory Update column in this issue of *EBPR*.

The new rules apply to amounts deferred after December 31, 2004, and to amounts deferred before January 1, 2005, under plans which are *materially modified* after October 3, 2004. Amounts deferred before January 1, 2005, under plans that are not materially modified after October 3, 2004, remain subject to existing tax rules. An amount is considered deferred before January 1, 2005, only if it is *earned and vested* before that date.

The Treasury Department is expected to issue guidance by December 21, 2004, on a number of key issues related to the new law. Companies should not wait until Treasury guidance is issued to begin preparing for the change in law. The following is a checklist of what to do (and not do) now.

## NONQUALIFIED DEFERRED COMPENSATION PLAN: ACTION CHECKLIST

- ✓ Establish Team
  - Establish team responsible for complying with new nonqualified deferred compensation law.
  - Include members from legal, tax, securities, HR, benefits, payroll and systems departments.
  - Include members from outside record-keepers and other administrators.
  - Include members from legal counsel and other outside consultants.
  - Define each member's roles and responsibilities.
- ✓ Become Familiar with Law
  - Read IRC Section 409A and Conference Report.
  - Review summary in this issue's Regulatory Update and summaries prepared by legal counsel and other outside consultants.
  - Look for key Treasury guidance to be issued by December 21, 2004.
- ✓ Inventory Plans, Award Agreements and Forms.
  - Identify each nonqualified deferred compensation plan, arrangement and agreement that may be subject to the new law, including for example:
    - Traditional nonqualified deferred compensation plans which allow elective deferrals of salary and bonuses;
    - Supplemental executive retirement plans (SERPs);
    - Excess pension and excess savings plans;
  - Short and long-term incentive plans with deferred compensation provisions;
    - Employment, severance, change of control and consulting agreements with deferred compensation provisions;
    - Ineligible IRC Section 457(f) plans for state and local governments and tax-exempt entities; and
    - Equity-based arrangements, such as discount stock options, phantom stock, stock appreciation rights (SARs), restricted stock units (RSUs) and membership appreciation rights (MARs) and any other equity-based arrangement that provides for the deferral of compensation.
- Identify administrative forms used to make initial deferral elections, change deferral elections and to designate beneficiaries.
- Identify deferrals made under affected plans. Review award agreements and elections forms. (Remember to review change in election forms too.)
- Determine whether deferred amounts are

“earned and vested” as of December 31, 2004, (and therefore grandfathered if not materially modified after October 3, 2004) or not earned and vested as of December 31, 2004 (and therefore subject to the new rules).

✓ Review Plans to Determine

Compliance with New Law

- Determine what changes are needed to comply with the new law. Review in particular the following provisions:
- Initial deferral elections. Make sure initial elections meet the following requirements:
  - Elections generally must be made by December 31st of the year before services to which deferred compensation relates are performed;
  - For new participants, election may be made within 30 days of first becoming eligible and must be made for unearned amounts only; and
  - For qualifying performance-based compensation with a performance period of at least 12 months, election must be made no later than six months before the end of the performance period and before attainment of performance goals are readily ascertainable.
- Subsequent (also called “second”) deferral elections. Make sure subsequent elections may *only* be made if the election:
  - Does not take effect until at least 12 months after the date on which the election is made;
  - Except in cases of death, disability or unforeseeable emergency, defers payment for at least five years after the date payment would otherwise have been made; and
  - For elections to defer payment to a specified time or

under a fixed schedule, is made at least 12 months before the date of the first scheduled payment.

- Distributions. Make sure distributions may *only* be made upon separation from service (six month wait required for key employees of public companies), death, disability, specified time or under fixed schedule, change in control and unforeseeable emergency. Treasury is expected to issue guidance on separation from service and change in control. Definitions of disability and unforeseeable emergency are set out in IRC Section 409A.
  - Acceleration of benefits. Eliminate “haircuts” (where participant agrees to forfeit portion of a portion of his or her benefits (typically 10%) in exchange for an earlier payment of benefits) and other impermissible acceleration features.
  - Offshore trusts and springing rabbi trusts. Look for prohibited offshore trusts and “springing rabbi trusts” (rabbi trusts funded on a change in the company’s financial health).
  - Remember to review plan documents, employment agreements, award agreements, employee communications, prospectuses, tax disclosures, payroll forms and procedures and administrative forms.
- ✓ Develop Action Plan for Each Affected Plan
- Determine whether to amend or replace existing plans. Where possible, consider establishing new plans for future deferrals. The two plan approach may be easier for participants and administrators to understand and may avoid inadvertent material modifications of existing plans.
  - Postpone making plan amendments until Treasury issues guid-

ance, to avoid making a material modification and imperiling grandfathered tax treatment under existing plans.

- Consider developing policy on whether tax “gross-up” provision will be added under certain circumstances.
  - Determine what approvals (board, committee and shareholder) will be required.
  - Coordinate with team members.
- ✓ Educate Company and Executives
- Educate board and compensation committee members, executives and other plan participants, and HR, benefits, payroll and systems about the new law and required action.
- ✓ Proceed with 2005 Deferral Elections
- Consider proceeding with 2005 deferral elections under existing procedures. This should enable the election to qualify for transitional relief to be issued by Treasury. Provide a cover memo to participants explaining the new law and the likelihood that changes may be required.
- ✓ Postpone Granting SARs and Other Questionable Equity-Based Awards (Until Further Guidance Is Issued)
- Postpone granting SARs, RSUs, MARs and other questionable equity-based awards until Treasury issues guidance. It is hoped that Treasury will provide guidance on how these forms of compensation will be treated under IRC Section 409A.
- ✓ Review Board, Committee and Shareholder Approvals
- Review the schedule of board and compensation committee meetings in the next month and year.
  - For equity-based plans subject

to the new rules, consider what shareholder approvals are required and when.

- Consider delegating authority to a committee to take certain actions in the event quick action is required before a board meeting may be held.
- ✓ Implement Internal and External Controls

- Implement internal and external controls to comply with new law and to avoid materially modifying otherwise grandfathered deferred compensation.
- Coordinate with team members and other internal and external people responsible for complying with the new law. 🌐

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