

Nonqualified Deferred Compensation: New Legislation Imposes Stricter Rules and Penalties

The American Jobs Creation Act of 2004, which contains important new provisions regarding nonqualified deferred compensation plans and arrangements, was passed by the House of Representatives on October 7, 2004 and by the Senate on October 11, 2004. The Act will now go to President Bush, who is expected to sign it. The Act, which covers a wide range of nonqualified deferred compensation plans and arrangements, imposes a number of strict requirements that such plans and arrangements must satisfy in order for participants to avoid immediate taxation. In addition, participants affected by nonqualified deferred compensation plans and arrangements that do not meet the new requirements are subject to significant penalties.

Impact of New Requirements on Nonqualified Deferred Compensation

Scope

The Act applies to all plans and arrangements that provide for the deferral of compensation, other than qualified employer plans (such as 401(k) and 457(b) plans), and *bona fide* vacation leave, sick leave, compensatory time, disability pay or death benefit plans. Accordingly, this broad definition would apply not only to traditional salary and bonus deferral plans, but to increasingly popular equity compensation awards, such as stock appreciation rights (SARs), restricted stock units (RSUs), phantom units, and possibly other equity compensation arrangements.

A stock option, however, will not be considered "nonqualified deferred compensation" (and thus will not be subject to the Act) if the option (i) is granted with an exercise price that is not less than the fair market value of the underlying stock on the grant date and (ii) does not include a deferral feature other than the right of the optionholder to exercise the option in the future. A conference report on the Act also clarifies that the Act is not intended to change the tax treatment of incentive stock options (ISOs) and purchase rights granted under employee stock purchase plans (ESPPs).

Immediate Taxation and Penalties

If a nonqualified deferred compensation plan or arrangement fails to comply with any of the new requirements, then (i) all compensation deferred under the plan or arrangement for an affected participant will become includible in the participant's gross income for the taxable year in which the failure occurs, (ii) interest at the underpayment rate plus 1% will be imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture, and (iii) the amount required to be included in income would be subject to an additional 20% penalty. The Act makes clear that current income inclusion, interest, and the additional tax apply only to participants with respect to whom the failure relates.

Initial Deferral Elections

The Act requires that a participant must make his or her initial election to defer

compensation for services performed during a taxable year by no later than the end of the preceding taxable year. For example, a participant who wishes to defer compensation earned with respect to services performed in 2005 is required to make a deferral election by December 31, 2004. The time and form of distribution must be specified at the time of initial deferral. As is currently the case, a new participant would be permitted to make an initial deferral election within 30 days after the participant first becomes eligible to participate in the plan.

The Act includes an exception for certain performance-based compensation. An election to defer performance-based

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compensation may be made no later than 6 months prior to the end of a performance period if the following criteria are met: (i) the performance period must be at least 12 months, (ii) the amount of the compensation must be variable and contingent on the satisfaction of preestablished organizational or individual performance criteria and not readily ascertainable at the time of the election. According to the conference report for the Act, it is expected that IRS regulations will provide that performance criteria would be considered preestablished if they are established in writing within 90 days after the commencement of the performance period.

Subsequent Deferral Elections

Under the Act, subsequent elections to change the timing or form of distribution are subject to certain requirements. A subsequent election to delay the timing or change the form of distribution cannot be effective until 12 months after the date the election is made. In addition, in the case of distributions scheduled to occur at a specified time, subsequent elections are allowed only if they are made at least 12 months prior to the date of the first scheduled payment. For distributions other than those paid upon death, disability or unforeseen emergencies, subsequent elections are required to defer payment for at least 5 years from the original payment date.

No Accelerated Payments or "Haircuts"

The Act prohibits the acceleration of distributions from their originally-scheduled payment date(s). Because of this restriction, nonqualified deferred compensation plans and arrangements would no longer be permitted to contain "haircut" provisions that allow participants to receive distributions subject to a penalty (e.g., 10%).

Distribution Elections

Generally, the Act provides that amounts may not be distributed prior to:

- ▶ separation from service (with an additional 6-month delay for "key employees" of publicly traded companies);

- ▶ disability;
- ▶ death;
- ▶ a date specified by the participant at the time of deferral (or pursuant to a fixed schedule elected by the participant);
- ▶ a change in control (subject to forthcoming IRS guidance); or
- ▶ the occurrence of an unforeseeable emergency.

For purposes of this provision, "key employees" generally include officers having annual compensation greater than \$130,000 (adjusted for inflation and limited to 50 employees), 5% owners, and 1% owners having annual compensation from the employer greater than \$150,000. The Act also provides definitions for "disability" and "unforeseeable emergency," and directs the IRS to issue guidance within 90 days after enactment on what constitutes a change in control for purposes of this provision.

Funding

Traditionally, employers have been able to set aside funds in so-called "rabbi trusts" without subjecting participants to current income taxation. A rabbi trust is a trust (i) that is owned by the employer, (ii) in which assets are set aside from the employer's other assets, (iii) under which the employer may not access the funds for working capital, and (iv) under which the funds are subject to the claims of the employer's creditors. The Act continues to permit the use of rabbi trusts, but imposes current income taxation, interest, and the 20% penalty described above on both offshore rabbi trusts and trusts with assets that become restricted to the payment of nonqualified deferred compensation upon a change in the employer's financial health.

Reporting Requirements

Amounts required to be included in income under the Act are subject to reporting and federal income tax withholding requirements. In addition, the Act requires employers to report deferred amounts on an individual's Form W-2 or Form 1099 for the year

deferred, even if the amount is not currently includible in income for that taxable year.

Effective Date

The Act is effective for amounts deferred in taxable years beginning after December 31, 2004.

In addition, amounts deferred prior to the effective date will be subject to the Act if the plan or arrangement under which the deferral was made is materially modified after October 3, 2004, unless the modification is made pursuant to forthcoming IRS guidance. The conference report clarifies that for this purpose, the addition of any benefit, right or feature is considered a material modification, but the exercise or reduction of an existing benefit, right or feature is not a material modification. Earnings on amounts deferred prior to the effective date will be subject to the Act only to the extent that the amounts deferred become subject to the Act.

The Act directs the IRS to issue guidance within 60 days after enactment that will provide a limited period during which a nonqualified deferred compensation plan adopted before December 31, 2004 may be amended to (i) conform the terms of the plan to the new requirements and (ii) provide participants with the opportunity to terminate participation in the plan or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, if such amounts are includible in the participant's income as earned.

Grandfathering

The conference report states that operating under the terms of a deferred compensation arrangement that complies with current law and is not materially modified with respect to amounts deferred before January 1, 2005 is permissible, since such amounts would not be subject to the Act. As an example, the conference report indicates that subsequent deferral elections with respect to amounts deferred before January 1, 2005

under a plan that is not materially modified after October 3, 2004 would not be subject to the Act. Therefore, allowing participants to exercise similar rights under a preexisting plan also should be permissible, even though such rights would result in immediate taxation and penalties if contained in a new or materially modified deferred compensation plan. For example, accelerated payments or “haircuts” also should be permissible for amounts deferred before January 1, 2005, if such payments are allowed under the terms of an arrangement that complies with current law and is not materially modified after October 3, 2004 with respect to such amounts.

What to Do Now

Analyze. Employers should analyze the provisions of their current deferred compensation plans and arrangements to determine whether any changes will be required under the Act.

Plan. If changes are required based on the new requirements of the Act, employers should prepare to amend their existing plans or arrangements or to adopt new plans or arrangements for amounts deferred after December 31, 2004. Please note, however, that if a plan or arrangement is materially modified after October 3, 2004, then amounts deferred in taxable years beginning before January 1, 2005 will be treated as amounts deferred in a taxable year beginning on or after January 1, 2005, unless the modification is made pursuant to forthcoming IRS guidance. Therefore, employers should consider preparing amendments to their existing plans and arrangements now, but delay the finalization and adoption of those amendments until the IRS issues its expected guidance.

Elect. Employers should prepare to have participants make elections to defer salary *and* bonus for services performed in 2005 prior to December 31, 2004, unless the bonus meets the exception for performance-based compensation outlined above. ■