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**EMPLOYEE BENEFITS ALERT: CONGRESS PASSES  
NONQUALIFIED DEFERRED COMPENSATION LEGISLATION**

As of October 11, 2004, both houses of Congress have passed the American Jobs Creation Act (the "Act"). President Bush is expected to sign the Act into law shortly. The Act significantly changes the federal tax laws that apply to nonqualified deferred compensation arrangements and will require most employers to change their executive deferred compensation plans. Significant penalties apply for failures to comply with the Act's provisions. Generally, the Act applies to amounts deferred after 2004, but **employers sponsoring nonqualified arrangements will need to take action by December 31, 2004 to comply with the Act.** This Employee Benefits Alert includes a summary of the key provisions of the Act, as well as a description of the actions that employers should take with respect to their nonqualified deferred compensation arrangements ("NQDC Plans").

Notably, certain previously proposed provisions have not been incorporated in the Act. These include provisions relating to the prohibition on deferrals of stock option gains and restrictions on investment options available to participants under NQDC Plans.

*Affected Arrangements*

The Act applies to all NQDC Plans. A NQDC Plan is defined in the Act as any plan, agreement or arrangement that provides for the deferral of compensation, including those that cover only one individual (*e.g.*, in an employment contract) and those that cover non-employees (including directors). The definition includes:

- account balance deferred compensation plans, including both elective and non-elective arrangements;
- nonqualified defined benefit plans (SERPs);
- excess benefit or wrap plans that are designed to provide benefits in excess of applicable Internal Revenue Code (the "Code") limits;
- equity compensation arrangements, including stock options with exercise prices less than the fair market value of the underlying stock on the date of grant, phantom stock, deferred stock, restricted stock and stock appreciation rights;
- Section 457(f) arrangements of tax-exempt and governmental entities; and
- any similar arrangement incorporated into an individual's employment agreement.

A NQDC Plan, however, does not include the following:

- Section 401(a) qualified retirement plans, including Section 401(k) plans, defined contribution plans and defined benefit plans, Section 403(b) tax-sheltered annuities, SIMPLEs and SEPs;
- Section 457(b) eligible deferred compensation plans;
- qualified governmental excess benefit arrangements designed to provide benefits in excess of the applicable Section 415 limits;
- bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans;
- stock options with an exercise price not less than the fair market value of the underlying stock on the date of grant that do not include the ability to defer gains attributable to stock option exercises;
- employee stock purchase plans; and
- annual bonuses or other annual compensation amounts paid within 2 ½ months after the close of the taxable year in which the relevant services required for payment have been performed.

#### *Initial Deferral Elections*

To comply with the Act, a NQDC Plan must require that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year or at such other time as will be provided in forthcoming IRS regulations. Newly eligible participants are permitted to make deferral elections within 30 days after becoming eligible to participate in the plan. However, such election will apply only to compensation earned for services rendered after the date of the election.

The Act provides a more lenient exception for "performance-based compensation" earned over a period of at least 12 months. Under this exception, an election to defer performance-based compensation may be made up to 6 months before the end of the performance period. The IRS has been directed to provide further guidance that defines what is performance-based compensation for this purpose. The Act's legislative history indicates that performance-based compensation will include compensation to the extent that the amount is (1) variable and contingent on the satisfaction of pre-established organizational or individual performance criteria, and (2) not readily ascertainable at the time of the election. The legislative history further indicates that performance-based compensation will likely be required to meet certain requirements similar to those under Code Section 162(m), including a requirement that the performance criteria be established in writing no later than 90 days after the commencement of the service period. A

determination by the compensation committee of the company's board of directors, however, will not be required.

*Distribution Restrictions*

The timing and form of NQDC Plan distributions must be either specified in the plan or designated by the participant at the time of deferral, subject to the timing requirements described above. However, distributions from NQDC Plans may only be made upon:

- the participant's separation from service (as defined by the IRS);
- the participant's death or disability;
- a specified time or pursuant to a fixed schedule specified under the plan at the time of the deferral;
- a change in the ownership or the effective control of the employer (to the extent permitted by the IRS); or
- the occurrence of an unforeseeable emergency.

Distributions to a "key employee" of a public company may not be made within the first six months following his or her separation from service. "Key employees" are more broadly defined than "reporting officers" subject to Section 16(b) reporting and short-swing profit liability. For this purpose, a key employee has the same meaning as used for qualified plan purposes and generally includes any employee who is an officer of the employer with annual earnings in excess of \$130,000 (adjusted for inflation and limited to the top 50 employees), a 5-percent owner of the employer or a 1-percent owner of the employer with annual earnings in excess of \$150,000.

A participant is considered "disabled" under the Act if he or she either (1) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of at least 12 months, or (2) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of at least 12 months, receiving income replacement benefits for a period of at least 3 months under any accident and health plan of the employer.

The Act defines an unforeseeable emergency as a severe financial hardship to the participant resulting from (1) an illness or accident of the participant or his or her spouse or dependent, (2) the loss of the participant's property due to casualty, or (3) similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. Distributions made on account of an unforeseeable emergency may not exceed the amounts necessary to satisfy the emergency, plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution after taking into account the extent to which the hardship will be relieved by insurance or liquidation of the participant's other assets.

### *No Acceleration of Benefits*

Under the Act, payments from a NQDC Plan may not be accelerated to a time before the date specified at the time of the election. This rule eliminates the use of “haircut” arrangements under which a participant agrees to forfeit a portion of his or her benefit in exchange for an early distribution, as well as other arrangements whereby amounts are distributed earlier than originally specified.

The Act authorizes the IRS to provide limited exceptions to the prohibition on accelerated distributions. The Act’s legislative history indicates that the following exceptions to the “no acceleration” rule are anticipated:

- an exception to provide for distributions to comply with federal conflict of interest requirements or a court-approved settlement incident to divorce;
- an exception to permit withholding of an employee’s share of employment taxes from his or her interest in the plan;
- an exception to permit a distribution to a participant to pay income taxes upon vesting under a Section 457(f) arrangement; and
- an exception to permit NQDC Plans to provide for the automatic distributions of minimal account balances upon permissible distribution events for purposes of administrative convenience (*e.g.*, a plan could provide that, upon a separation from service, a participant with an account balance of less than \$10,000 will receive an automatic lump sum distribution).

### *Subsequent Elections*

Under the Act, NQDC Plans may allow changes in the time and form of distributions that have the effect of delaying commencement of benefits, but only if the plan requires that:

- the subsequent election is not effective for at least 12 months after the date on which the election is made;
- except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the subsequent election provides for an additional deferral of at least 5 years from the date the payment would have otherwise been made; and
- if related to a payment at a specified time or pursuant to a fixed schedule, the subsequent election be made at least 12 months prior to the date of the first scheduled payment.

### *Consequences of a Violation of the Act*

If at any time a NQDC Plan fails to meet the election, distribution and no acceleration requirements discussed above, all compensation deferred under the plan for the taxable year and for all

preceding taxable years, as well as any earnings on such amounts, will be includible in the participant's gross income as soon as such amounts are no longer subject to a substantial risk of forfeiture. In addition, the tax imposed is increased by (1) interest, at the IRS underpayment rate plus one percentage point, on the underpayments that would have occurred had the compensation been taxable when first deferred or, if later, when not subject to a substantial risk of forfeiture, and (2) 20% of the amount of compensation that is required to be included in the participant's gross income.

Only plan participants to whom the violation relates are subject to these consequences. Thus, if a NQDC Plan properly includes the provisions required by the Act but makes an impermissible distribution to a participant, only that participant is subject to the tax implications described above. If, however, a NQDC Plan includes provisions that violate the provisions of the Act, all plan participants would be subject to the tax consequences described above.

#### *Rules Related to Funding*

In addition to the election, distribution and acceleration of benefits restrictions described above, the Act also imposes new limitations on the funding of NQDC Plan benefits.

#### Offshore Trusts

Under one such limitation, any assets set aside in a trust located outside of the United States for the purpose of paying benefits under a NQDC Plan are treated as property transferred under Code Section 83 at the time such assets are set aside, regardless of whether or not the assets are available to satisfy the claims of creditors. Thus, plan participants would be immediately taxed on such amounts, including any earnings thereon, when they are no longer subject to a substantial risk of forfeiture. Further, under the Act, the tax imposed on plan participants is increased by the sum of (1) 20% of the compensation that is required to be included in gross income, plus (2) interest, at the IRS underpayment rate plus one percentage point, on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which it was first deferred or, if later, the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture.

The Act includes an exception to this rule for assets located in a foreign jurisdiction if substantially all of the services to which the deferred compensation relates are performed in that foreign jurisdiction. The IRS has authority to exempt other offshore arrangements from the rule if they do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

#### Triggers Upon Financial Health

The Act also provides that compensation deferred under a NQDC Plan will constitute property subject to taxation under Code Section 83 if the plan provides that, upon a change in the employer's financial health, assets will be restricted to the payment of plan benefits. Thus, if

a NQDC Plan provides that, upon a change in the employer's financial health, a trust will become funded to the extent of deferrals made under the plan, the deferred amounts (and any earnings thereon) are taxable to the plan participants when they are no longer subject to a substantial risk of forfeiture. It should be noted that the Act provides that the property transfer results even if the assets that become restricted upon the change in financial health are subject to the claims of creditors. However, the Act indicates that this provision is not intended to apply when assets are restricted to the payment of NQDC Plan benefits for a reason other than a change in financial health (*e.g.*, upon a change in control) or if assets are periodically restricted under a structured schedule and scheduled restrictions happen to coincide with a change in financial status. The amounts that become taxable pursuant to this provision are also subject to interest, at the IRS underpayment rate plus one percentage point, and the 20% penalty, as described above.

#### *Reporting Requirements*

Amounts required to be included in income under the Act must be reported on the participant's Form W-2 (or Form 1099 for non-employees) for the year includible in income. Such amounts are also subject to federal income tax withholding.

In addition, the Act requires that amounts deferred under a NQDC Plan be reported to the IRS on the participant's Form W-2 (or Form 1099 for non-employees) for the year such amounts are deferred, even if the amounts are not currently includible in income for the taxable year. The IRS is granted regulatory authority to establish a minimum amount of deferrals below which the reporting requirement will not apply. In addition, the IRS has also been granted authority to provide for later reporting of amounts deferred under a non-account balance plan that are not readily ascertainable.

#### *Effective Date*

The Act applies to amounts deferred in taxable years beginning after December 31, 2004. The legislative history indicates that an amount is considered deferred before January 1, 2005, if the amount is earned and vested before such date. (This vesting requirement may pose particular problems for those Section 457(f) arrangements which were established before the effective date of the Act, but which vest after January 1, 2005.) Earnings on amounts deferred before 2005 are subject to the provisions of the Act only to the extent that the deferrals are subject to the Act.

In addition, amounts deferred in taxable years beginning before January 1, 2005 are subject to the Act if the NQDC Plan under which the deferral is made is materially modified after October 3, 2004. The Act's legislative history states that the addition of any benefit, right or feature is a material modification. Examples of material modifications include accelerating vesting under a plan after October 3, 2004 and a post-October 3, 2004 amendment to add a provision permitting distributions upon request if participants are required to forfeit 10% of the amount of the distribution. However, the exercise or reduction of an existing benefit, right or feature is not a material modification. Further, the Act indicates that a NQDC Plan may be

amended in accordance with IRS guidance to add the new rules for post-2004 deferrals without jeopardizing the grandfathered status of pre-2005 deferrals under the plan.

The Act directs the IRS to issue guidance within 60 days after the enactment of the Act, providing a limited period of time during which a NQDC Plan adopted before December 31, 2004 may be amended without violating the Act to (1) permit participants to terminate participation in the plan or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, provided that those amounts are includible in income as earned or, if later, when not subject to a substantial risk of forfeiture, and (2) to conform with the provisions of the Act with respect to amounts deferred after 2004. In addition, the legislative history indicates that it is expected that the IRS guidance may provide exceptions to certain requirements of the Act during the transition period and that the IRS will provide a reasonable time during the transition period, but after the issuance of guidance, for NQDC Plans to be amended.

#### *Forthcoming Regulations*

The Act directs the IRS to prescribe regulations that are necessary to carry out the purposes of the Act, including regulations: (1) providing for the termination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) defining financial health; and (4) disregarding a substantial risk of forfeiture where necessary to fulfill the purposes of the Act. In addition, the Act's legislative history indicates that the IRS may also issue regulations relating to stock appreciation rights.

#### *Required Action*

In response to the Act, employers with NQDC Plans should immediately begin taking the following steps:

- Employers should determine which of their plans and individual arrangements could be affected by the Act. In addition to traditional elective deferred compensation arrangements and SERPs, these plans may include Section 457(f) arrangements and certain equity compensation programs, including restricted stock units, performance units, stock appreciation rights and phantom stock awards.
- Once the affected plans are identified, employers will need to determine what changes will be necessary to comply with the Act. These may include:
  - eliminating haircut provisions;
  - eliminating provisions as to the timing and form of distributions from NQDC Plans that are tied to elections under a qualified plan;
  - amending deferral election timing requirements to comply with the Act (including the special election timing rules for performance-based compensation);

- amending provisions relating to subsequent deferrals of scheduled distributions to provide for a minimum additional deferral period of at least 5 years from the date of the originally scheduled payment date;
  - adding provisions in the NQDC Plans of public companies to prohibit distributions to a key employee within the 6 month period immediately following his or her separation from service; and
  - eliminating plan provisions that permit participants to change a scheduled form of payment from installments to a lump sum.
- Affected plans will need to be amended to the extent necessary to comply with the Act's provisions. As noted above, the IRS will likely permit affected plans to be amended after 2004 to comply with the Act. However, given the January 1, 2005 effective date, it is highly recommended that the employer's board of directors act **before the end of 2004** to authorize any and all amendments to be made to the employer's non-qualified deferred compensation arrangements. Care should be taken in amending any affected plan to be sure that the amendment will not adversely effect the availability of the grandfathering provision for pre-2005 deferrals. Since pre-2005 vested deferrals are not subject to the Act (absent a material modification), employers may want to consider freezing their existing plans as of the end of 2004 and create new plans that will apply to amounts deferred after 2004.
- Public company employers should be sure to consider the applicable securities laws issues presented by amending their existing plans or adopting new ones. **Generally, the establishment or material amendment of a deferred compensation plan by a public company will need to be reported to the SEC on a Form 8-K within four business days, and the new plan or amendment will typically need to be included with the company's next Form 10-Q or 10-K.** In addition, the company should consider the shareholder approval requirements under the NYSE or NASDAQ listing standards and the need to file a Form S-8 with the SEC or the need to amend a previously filed Form S-8.
- Employers should communicate to participants the requirements of the Act and their impact on the affected plans and the participants' deferrals.
- Election forms and other administrative forms used in connection with affected plans will likely need to be revised to comply with the plan amendments required by the Act.

If you have any questions about the new Act or its effect on your deferred compensation arrangements, please call.

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