AMERICAN JOBS CREATION ACT OF 2004 MAKES SWEEPING CHANGES TO DEFERRED COMPENSATION RULES

The American Jobs Creation Act of 2004 makes sweeping changes to the rules governing nonqualified deferred compensation. The full impact of the new law is not yet clear, nor are the steps employers will need to take in response to it. Based on briefings provided by the Treasury, we expect that guidance on significant issues will be issued by December. This guidance is expected to provide ample time to bring existing plans into compliance.

We will be monitoring new developments closely and will update this memorandum when formal Treasury guidance is available.

Highlights

- **Scope.** The Act adds new Section 409A to the Internal Revenue Code. Section 409A applies broadly to public, private and not-for-profit entities. It applies to employees and independent contractors and affects virtually all forms of nonqualified deferred compensation, including many equity-based awards.

- **Effective Date.** Section 409A applies to amounts deferred for 2005 and beyond. Compensation deferred for earlier years will be grandfathered only if it is both *earned* and *vested* on or prior to December 31, 2004. *This grandfather protection will be lost if an existing plan is "materially modified" after October 3, 2004, except to conform to the new rules in a manner prescribed by the Treasury.* Existing plans should *not* be amended in advance of Treasury guidance. Care must also be taken in exercising discretion under existing plans, as certain discretionary actions (such as acceleration of vesting or plan termination) may be treated as material modifications.

- **Transition Guidance.** The Treasury is expected to provide transition guidance before year-end regarding the timing and nature of amendments needed to bring plans into compliance with Section 409A. Treasury officials have stated that plans and arrangements affected by the new rules will not need to be amended by year-end, although the exact scope and nature of transition relief is not known at this time.

- **Penalties for Noncompliance.** Section 409A significantly raises the stakes for violations of the rules governing nonqualified deferred compensation. Amounts deferred under plans or arrangements that do not comply will be taxed when earned or, if later, when vested, and will also be subject to a 20% penalty tax. The tax exposure falls solely on affected employees, although as a practical matter employers will be responsible for ensuring that the rules are met.

- **Covered Plans and Arrangements.** Section 409A applies to elective and nonelective deferred compensation plans, annual and long-term incentive plans that include deferral features, so-called "excess benefit plans," supplemental executive retirement plans (SERPs) and deferral arrangements covering one person, including employment and consulting agreements that provide for installment or deferred payouts on termination of employment. It also applies to stock appreciation rights and restricted stock units (sometimes called "phantom stock").

- **Effect on Stock Options**. To the extent provided by the Treasury, Section 409A will also apply to "discount options" (i.e., options granted at an exercise price less than the fair market value of the underlying shares on the grant date). This new rule could have implications for option grant practices of private companies, where stock values are not readily ascertainable. Section 409A may also impact conventional practices for treatment of options (and other equity-based awards) in M&A transactions, such as option rollover and cash-out provisions.

- **Excluded Plans and Arrangements.** Section 409A does not apply to bona fide welfare benefit plans (e.g., sick leave and disability plans), tax-qualified retirement plans, "incentive stock options" (ISOs) or qualified employee stock purchase plans (Section 423 Plans). Traditional restricted stock (as opposed to restricted stock "units" or phantom stock) is also unaffected.

- **Timing of Deferral Elections**. For covered plans, deferral elections will generally need to be made in the taxable year preceding the year in which compensation (such as salary or bonus) is earned. Later elections are permitted for certain "performance-based" bonuses.

- **Limited Permissible Distribution Events**. Covered plans must limit the events that can trigger distributions. Permissible events are termination of employment, a specified date or dates, death, disability, certain unforeseen emergencies and a change in control. *For key employees of public companies, distributions upon termination of employment must be delayed for six months from the date of termination.* For a service organization that defers its compensation and enters into a back-to-back deferral plan with its partners, members or employees, pending Treasury guidance, it is not clear whether a permissible distribution event under the plan for partners, members or employees will permit the organization to receive a corresponding distribution under its deferral plan.

- **Offshore Funding Arrangements Prohibited**. Section 409A prohibits the funding of deferred compensation through offshore trusts and, under future Treasury regulations, other arrangements located outside the U.S.

- **First Steps for Employers.** Employers should identify all covered plans and arrangements, including equity-based plans, whether maintained pursuant to formal plans or as part of individual agreements. Plan documents, amendments, election forms and employee communications relating to covered plans and arrangements should be assembled for review.

- **Elective Deferrals for 2004 Bonuses and 2005 Compensation**. According to Treasury officials, employers that maintain elective nonqualified deferred compensation plans should proceed with obtaining deferral elections for 2004 bonuses and 2005 compensation before the end of this year, and otherwise act in accordance with current practices. We believe, however, that plan participants should be provided with notice of the potential implications of the new rules (e.g., that distribution events for new deferrals may need to be changed to comply with the new rules, and that failure to comply will result in imposition of income and penalty taxes).
- **Securities Act Prospectuses.** Prospectuses for deferred compensation and equity plans registered on Form S-8 will need to be amended to reflect the tax law changes.

Discussion of the New Law

A general discussion of some of the principal provisions of Section 409A follows. *Unless otherwise noted, this discussion applies only to deferred compensation that is not grandfathered by the transition rules (i.e., deferred compensation not earned and vested on or prior to December 31, 2004, and deferred compensation payable under an existing plan or arrangement that is materially modified after October 3, 2004).*

Legislative and Regulatory Framework

Section 409A adds additional restrictions to the current noncodified rules governing nonqualified deferred compensation. The full impact and scope of Section 409A, though clearly substantial, will not be known until formal Treasury guidance is issued. The Treasury is expected to issue "priority" guidance on key issues (including transition) by December. Subsequent guidance on less time-sensitive issues is also expected.

Excluded Plans

Section 409A does not apply to (i) qualified plans under Section 401(a) of the Code, such as 401(k) plans and pension plans, (ii) tax-deferred annuities, (iii) simplified employee pension plans (SEPs), (iv) simple retirement accounts under Section 408(p) of the Code, (v) certain governmental and tax-exempt plans under Sections 457 and 415 of the Code and (vi) bona fide vacation, sick leave, compensatory time, disability and death benefit plans.

Interest and Penalties for Failure to Comply

If at any time during a taxable year a covered plan fails to meet the requirements of Section 409A with respect to one or more participants, either in form or operation, all compensation deferred under the plan for that taxable year and all preceding taxable years will be includible in income of the affected participants, to the extent not subject to a substantial risk of forfeiture and not previously included in income. Amounts includible in income will be subject to interest at the underpayment rate plus 1%, and an additional penalty tax of 20%.

New Rules Affecting Deferrals and Distributions

Initial Deferral Elections. Section 409A requires that voluntary deferral elections be made not later than the end of the taxable year preceding the taxable year during which services are performed with respect to the compensation to be deferred. There are two exceptions.

(1) During the first year of plan eligibility, a participant may elect to defer future compensation for that year within 30 days after becoming eligible to participate in the plan.

(2) Deferral elections for "performance-based compensation" paid in respect of services to be performed over a period of at least 12 months may be made up to six months prior to the end of the performance period. "Performance-based compensation" will be defined in Treasury guidance, although the definition is expected to be less stringent than that currently used under Section 162(m) of the Code.

Subsequent Elections. Section 409A allows for subsequent elections to change the form of distribution and/or postpone a preselected distribution date, subject to the following requirements.

(1) The new election may not be effective for at least 12 months from the date it is made.

(2) If the new election relates to payments otherwise scheduled to be made on a specified date or dates, it must be made at least 12 months prior to the first scheduled payment under the prior election.

(3) "Redeferral elections," which postpone previously deferred payments scheduled to be paid upon (a) a specified date or dates, (b) separation from service, or (c) a change in control, must provide for an additional deferral of at least five years from the date of the first originally scheduled payment.

Acceleration of Distributions. Section 409A requires all covered plans to prohibit acceleration of distributions, except as allowed by Treasury regulations. This provision puts an end to the practice of allowing early distributions in exchange for forfeiture of a percentage of the amount to be distributed, sometimes referred to as a "haircut" provision. It is expected that the Treasury will make limited exceptions to the prohibition on acceleration of distributions, such as, for example, where acceleration is necessary to satisfy employment tax withholding requirements.

Permitted Distributions. Under Section 409A, a nonqualified deferred compensation plan may allow distributions *only* upon the following events.

(1) The date of a participant's *separation from service*. For public companies, distributions upon separation from service for "key employees," defined as the top 50 officers of the employer having annual compensation greater than $130,000, 5% owners and 1% owners having annual compensation greater than $150,000, must be delayed for *six months* beyond separation from service.

(2) The date a participant becomes *disabled or dies*. A participant is considered disabled if he or she is subject to a physical or mental impairment that is expected to last for at least 12 months or result in death and as a result of such condition (a) is unable to engage in any substantial gainful activity or (b) has been receiving income replacement benefits for at least three months under an accident health plan of the employer. (This definition of disability is narrower than those typically used in deferred compensation plans.)

(3) A date *or series of dates* specified under the plan or deferral election. The rules provide that a date certain may not include an "event." For example, an election to defer payment until an individual turns 65 is a permissible deferral until a date certain, while an election to defer payment until an IPO is an impermissible deferral until the occurrence of an event.

(4) A *change in control* of the employer. The Treasury is required to provide guidance on distributions to be made on a change in control.

(5) The occurrence of an *unforeseeable emergency*. Section 409A defines "unforeseeable emergency" as a severe financial hardship resulting from an illness or accident, loss of property due to casualty, or other similar extraordinary and unforeseeable circumstance that is beyond the control of the participant. Distributions must be limited to the amount necessary to satisfy the emergency plus an amount equal to the expected taxes on the distribution. Such distributions can only be made to the extent that the emergency cannot be relieved from insurance coverage or a liquidation of the participant's personal assets (to the extent that such liquidation would not itself cause severe financial hardship).

Prohibited Arrangements

Section 409A specifically prohibits two types of arrangements currently used in some nonqualified deferred compensation plans.

Offshore Funding Vehicles. If assets are set aside in a trust for the purpose of paying deferred compensation, and if either the trust or the assets are located outside the U.S., amounts deferred will be includible in income and subject to the 20% penalty tax, to the extent vested, regardless of whether such assets are available to satisfy the claims of the employer's general creditors. Subsequent increases in the value of such assets will also be includible in income and subject to the penalty tax. The Treasury is authorized to promulgate regulations under which assets set aside outside the U.S. in "other

arrangements" will be subject to the same tax regime. These provisions do not apply to offshore funding vehicles if substantially all of the services to which the nonqualified deferred compensation relates are performed in an offshore jurisdiction.

Financial Health Triggers. Under some nonqualified deferred compensation plans, upon an adverse change in the employer's financial health, assets are required to be set aside or otherwise restricted so that they can be used for the payment of deferred compensation obligations. Under Section 409A, compensation deferred under such arrangements will be subject to income and penalty taxes on the earlier of (1) the date the plan first provides that assets are to be set aside or restricted, and (2) the date such assets are actually set aside or restricted, in each case regardless of whether such assets are available to satisfy the claims of the employer's general creditors.

Application to Equity Compensation Arrangements

Stock Options. The extent to which the Treasury will rework the established rules for compensatory options is unclear. Section 409A does not apply to stock options granted with an exercise price at least equal to the fair market value of the underlying shares on the date of grant. However, "discount options" (i.e., options granted at an exercise price less than the fair market value of the underlying shares on the grant date) that are granted *or vest* after December 31, 2004 are expected to be treated as deferred compensation, and will potentially be subject to both income and penalty taxes as they vest. It is unclear at this time whether the amount subject to tax will be the full value of the option upon vesting, the "discount" at grant or some other amount.

Stock Appreciation Rights. Stock appreciation rights that are granted *or vest* after December 31, 2004 are likely to violate Section 409A, although stock appreciation rights that provide (or are amended to provide) for automatic settlement upon vesting should be permissible.

Restricted Stock Units. Restricted stock units, which generally provide for delivery of stock to an employee on one or more fixed dates, are also covered by Section 409A. Settlement of restricted stock units that are granted *or vest* after December 31, 2004 must be limited to permissible distribution events. As with SARs, restricted stock units that provide (or are amended to provide) for automatic settlement upon vesting should be permissible.

Treasury guidance is expected to clarify the issues affecting discount options and other equity-based awards. Outstanding, unvested awards may need to be amended (as provided by the Treasury) to avoid adverse tax consequences. The expected prohibition on grants of discount stock options may require private companies to reassess stock valuation practices currently used in setting exercise prices for options. Treasury guidance should also clarify how equity-based awards may be treated in M&A and private equity transactions.

Withholding and Reporting to the IRS

Employers are subject to reporting and withholding requirements on deferred compensation required to be included in an employee's income under Section 409A. Employers will also be required to report deferred compensation on each employee's Form W-2 (and on each Form 1099 for directors and independent contractors) for the year such compensation is deferred.

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