Hahn Loeser & Parks LLP

TAX ADVISORY—Impact of American Jobs Creation Act of 2004 on Deferred Compensation Arrangements

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Summary

On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 (the "Act") into law. The Act includes sweeping changes to the rules governing nonqualified deferred compensation arrangements. Consequently, all employers should familiarize themselves with these rules and make the necessary changes to their plans, possibly by the end of 2004, in order to avoid (i) the immediate taxation of deferred compensation, and (ii) the imposition of interest penalties and a 20% excise tax.

Essentially all nonqualified deferred compensation plans and arrangements are affected, including: deferred compensation portions of individually negotiated employment agreements, severance agreements, salary and bonus deferral plans, SERPs, stock appreciation rights, restricted and phantom stock plans, and many stock option plans. Generally, the Act applies to plan years beginning after December 31, 2004 and to prior compensation deferrals that are "materially modified" after October 3, 2004.

Increased Restrictions on Deferral

Under pre-Act law, an employer enjoyed great flexibility when designing deferred compensation arrangements and had to address few restrictions on plan design. In comparison, the Act now requires that plans meet certain, more stringent design criteria relating to the timing of deferral elections and benefit distributions.

The Act requires that participants make compensation deferral elections no later than the last day of the preceding plan year (*e.g.*, December 31, 2004 for deferrals to be made during 2005). Limited exceptions are available for (i) first-time participants and (ii) deferrals of performance-based compensation attributable to services rendered over at least 12 months. The Act allows for changes to initial deferral elections, so long as the change does not take effect for 12 months and the new distribution date is deferred for at least 5 years after the original date. Moreover, with respect to an election to defer until a specified date, the new election must be made at least 12 months prior to the date of the first distribution that otherwise would have been made under the prior election.

Under the Act, plan participants may receive distributions from the plan only upon one of the following events: separation from service,[1] disability, death, the

[1] For certain officers of public companies, the distribution must be made at least six months after separation from service.

occurrence of a date established when the deferral election was made, a change in control of the employer, and unforeseen emergencies that result in severe financial hardship. Moreover, the Act prohibits the acceleration of distributions – even if the amount distributed is subject to a "haircut" (*i.e.*, the participant is financially penalized by reason of the early distribution).

Impact on Certain Funding Vehicles

The Act requires that contributions to a Rabbi Trust arrangement (*e.g.*, the use of a trust to secure an employer's promises under a deferred compensation plan) held outside the United States be considered as a taxable transfer of property to the recipient. However, to accommodate Americans working outside the United States, the Act includes a limited exception for Rabbi Trust contributions that benefit participants who are living and working in a foreign jurisdiction when the related plan is established and maintained in that same jurisdiction.

In addition, the Act provides that contributions to trust arrangements that include "employer financial health triggers," such as a Rabbi Trust that prohibits claims from the employer's creditors if certain financial triggers are met, must be included in the employee's taxable income at the time of contribution.

Suggested Actions for Employers with Affected Plans

Prior to year-end, all employers should determine which of their nonqualified deferred compensation plans are impacted by the Act. As noted above, a broad range of plans, including individual arrangements, are covered by the new rules. Further, an employer might wish to "freeze" an existing plan, *i.e.*, make no further contributions and adopt a new plan for post-2004 contributions which is compliant with the new law, so that the old plan is not subject to the new rules. Otherwise, the employer should begin the implementation of plan amendments and employee elections that will result in its plans being in compliance with the Act and also obtain appropriate (*i.e.*, shareholder, compensation committee, board and/or SEC) approvals for such plans.

The Act requires the IRS to promptly issue guidance on how the new rules impact nonqualified deferred compensation arrangements. Employers should be on the watch for this guidance. Members of Hahn Loeser & Parks LLP's Taxation and Employee Benefits group are available to help employers comply with the new law and guidelines.