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New Legislation May Require Extensive Changes for New & Existing Executive Compensation Arrangements

By Steven Friedman

The American Jobs Creation Act of 2004 (the "Act") was passed by Congress on October 11 and is expected to be signed into law by the President shortly.

If enacted, this legislation will make significant changes to rules relating to deferred compensation arrangements, and will affect a considerable number of programs that have been established to benefit corporate executives. Although the Act principally impacts deferred compensation plans, it may also impact SERPs, "excess" plans, certain equity compensation arrangements, severance arrangements, 457(f) plans (for tax-exempt entities) and other "non-qualified" vehicles which provide a mechanism for the deferral of income.

This legislation is effective for compensation deferred on or after January 1, 2005 — plans and programs affected by the legislation must be amended prior to this date. A failure to timely comply with the provision to the Act could cause the immediate taxation of amounts which have been deferred.

Certain plans and pay practices are not subject to the Act. These include annual bonuses paid within 2½ months after the year in which they were earned, nonqualified stock options issued at fair market value, incentive stock options and employee stock purchase plans.

The Act's Impact on Executive Compensation Arrangements

Initial Deferred Elections

Participant elections to defer compensation must be made before the beginning of the tax year in which the services are performed (e.g., a deferral election affecting a portion of an employee's salary earned during calendar year 2005 would generally need to be made during 2004.)

Exception for "Performance-Based Compensation"

If compensation is earned over a period of at least twelve months and can be classified as "performance-based" (certain bonus plans should fall within this category), an initial deferral election may be made as late as six months before the end of the measurement period.

Example: A deferral election could be made as late as June 30, 2005 for a bonus which is based upon calendar year 2005 performance.

"Performance-Based Compensation" will be defined in Treasury regulations which should be issued within 60 days of the Act's enactment. According to the Congressional Conference report released with the legislation, it is quite feasible that "performance-based compensation" will be limited to amounts which are contingent upon objective performance criteria. Therefore, annual discretionary bonuses that may be deferred under a deferred compensation plan may require a deferral election prior to the beginning of the measurement period.

Exception for First Year of Plan Eligibility

When an individual first becomes eligible to participate in a deferred compensation plan, a deferral election may be made within 30 days of his or her eligibility date and may apply only to compensation which is earned after the election date.

Subsequent Deferral Elections

Often plans which permit participants to defer compensation allow distributions to commence at a fixed point (or points) in the future. Although not sanctioned by the IRS, deferred compensation plan sponsors, relying on court rulings, often permit participants to revise this election. The Act officially sanctions subsequent deferral elections provided that (i) any such election becomes effective no earlier than 12 months after it is made, (ii) the new distribution commencement date is at least 5 years later than the original date, and (iii) if the initial election was to defer a distribution until a specific date (as opposed to an event, such as termination of employment), the subsequent election must be made at least 12 months before the first scheduled distribution.

Restrictions on Distributions

The Act requires that a plan or a participant must designate when plan distributions will be made at the time that compensation is deferred. Amounts which have been deferred will be permitted to be deferred only: (i) upon separation from service (to be defined in Treasury Regulations) however, at public companies, distributions to "key employees" generally may not be made earlier than six months after separation from service; (ii) upon participant's disability; (iii) upon participant's death; (iv) on a specific date or on specific dates; (v) upon an unforeseeable emergency which is defined as a participant's severe financial hardship resulting from illness or accident of the participant, his or her spouse or dependent, loss of participant's property due to casualty, or similar extraordinary and unforeseeable circumstances; or (vi) upon a change in control (to be defined in Treasury regulations).

The Act prohibits the acceleration of payments before the time that they are scheduled to be made. This means that installment or annuity distributions cannot be converted to a lump sum, nor can so called "haircut" distributions be made where a participant takes an unscheduled withdrawal and forfeits a percentage (usually 10%) of the principal. Another now prohibited practice is to tie the timing and/or form of deferred compensation plan distribution to the election he or she makes under a qualified retirement plan.

Practices Not Affected by Act

Prior legislative proposals would have restricted plan investments to those which mirrored 401(k) plan investments. The Act does not mandate what types of investments an employer can offer. Prior proposals also prohibited the deferral of stock option and restricted stock gains. These restrictions were not included in the Act.

What Should Employers Do?

As stated above, it is very likely that the Act will be signed into law by the President shortly. If enacted, it will affect a huge number of deferral arrangements, sponsored by employers.

In light of the short timeframe that employers will have to revise their plans, it is advisable that arrangements which are subject to the Act should be identified and their provisions examined to determine what changes need to be made. Employers may keep in mind that Treasury regulations will likely be issued prior to the 2005 effective date so all aspects of a plan affected by the Act may not be ripe for redesign immediately.

Because any changes that may be required likely will impact current plan participants, employee communications should be a key component of an employer's strategy in dealing with the effects of the Act.

Unless new guidance delays the Act's effective date, affected deferred compensation arrangements should be amended prior to January 1, 2005.

For further assistance, please consult one of our attorneys in the Employee Benefits Practice Group.