

# BUSINESS ALERT

*CURRENT LEGAL ISSUES FOR THE BUSINESS COMMUNITY*

March, 2005

Vol. 4, No. 2

## **NONQUALIFIED DEFERRED COMPENSATION: NEW FEDERAL LEGISLATION**

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The American Jobs Creation Act of 2004 (the "Act"), which contains important new provisions regarding nonqualified deferred compensation plans and arrangements, became effective in January, 2005. 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 and penalties.

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.

If a nonqualified deferred compensation plan or arrangement fails to comply with any of the new requirements, the (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 one percent (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 twenty percent (20%) penalty.

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 thirty (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 compensation may be made no later than six (6) months prior to the end of a performance period if the following criteria are met: (i) the performance period must be at least twelve (12) months, (ii) the amount of the compensation must be variable and contingent on the satisfaction of pre-established organizational or individual performance criteria and not readily ascertainable at the time of the election.

The Act prohibits the acceleration of distributions from their originally-scheduled payment date(s).

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

- Separation from service (with an additional six (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 ninety (90) days after enactment on what constitutes a change in control for purposes of this provision.

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.

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.

Many of our clients are setting up phantom plans and must be mindful of these new rules. You should also consider reviewing any current plans that are in place to determine the need for amendments or modifications of your plans.

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*Actual resolution of legal issues depends upon many factors, including variations of fact and state laws. This article is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this article.*