Nonqualified Deferred Compensation Legislation Passes

2004-10-12

The "American Jobs Creation Act of 2004," which includes significant changes to the tax treatment of nonqualified deferred compensation, has been passed by both houses of Congress and is awaiting the President's signature. The legislation provides that, where a nonqualified deferred compensation plan fails to satisfy certain new plan document or operational requirements, amounts deferred will be subject to current taxation, interest and penalties. The new regime, applicable to amounts deferred after December 31, 2004, potentially affects a broad range of plans providing deferred compensation, including elective deferral plans, SERPs, long-term incentive plans, and equity plans with SARs, restricted stock units (RSUs) or stock/option gain deferral features.

Action Needed

Elections to defer 2005 compensation must generally be made prior to December 31, 2004 and must be made under plans that comply with the new rules. With respect to vested compensation, a plan in place on October 3, 2004 and not materially modified will be analyzed under old law.

The legislative history suggests, however, that amounts not vested as of December 31, 2004 (such as bonuses conditioned on 2005 employment) may be subject to the new provisions, even if subject to an existing deferral election. For example, the new rules are potentially applicable to unvested RSUs, or to the deferral of restricted stock or option gains pursuant to current elections, if the underlying option or restricted stock is scheduled to vest after December 31, 2004.

Treasury is expected to issue guidance, no more than 60 days after enactment, providing a limited period during which existing plans may be amended to conform to the new law with respect to post-2004 deferrals. Also, such guidance should allow participants to terminate participation or withdraw elections for amounts deferred after this year, but only if the amounts are included in the participant's income as earned.

New Election Rules

- The deferral election must generally be made by the close of the taxable year preceding the year in which the underlying services are performed.
  Note: Treasury may issue rules clarifying election timing where the fiscal year of the

employer is not the calendar year.

- Newly eligible participants have 30 days to elect to defer.
- Elections to defer "performance-based compensation" based on a 12-month (or longer) performance period may be made six months prior to the close of the performance period. *Note*: Treasury is expected to issue regulations delineating "performance-based compensation" along the lines of the performance-based compensation exception to section 162(m).
- "Second elections" must be made at least 12 months in advance, and must postpone the scheduled payment for at least five years from the date the payment would otherwise be made.

Limits on Distribution Events

A nonqualified deferred compensation plan may allow distributions only upon the following events:

- Separation from service (six months after separation for certain key employees of public companies)
- Death
- At a specified time or according to a fixed schedule specified at the time of the deferral
- Change in control of a corporation (as defined in Treasury guidance due within 90 days of enactment)
- Occurrence of an unforeseeable emergency (a tighter standard than mere "hardship")
- Participant disability
  Note: There is no explicit provision concerning distributions upon the termination of plans, an issue that may be addressed in regulations.

Other Changes and Questions

Other important provisions include immediate taxation of "rabbi trusts" funded upon employer financial health triggers; clarification that there is no FICA tax in connection with ISOs or ESPPs and no income tax withholding on disqualifying dispositions of such options; Form W-2 or 1099 reporting of deferrals; and transition relief. Many details of the new requirements must be clarified through Treasury Regulations.

For more guidance on the new provisions and how they may apply to your compensation programs, please contact the attorneys listed above.

Authors

R. Scott Kilgore

PARTNER

scott.kilgore@wilmerhale.com

+1 202 663 6116

Amy A. Null

PARTNER

amy.null@wilmerhale.com

+1 617 526 6541

Linda K. Sherman

RETIRED PARTNER

+1 617 526 6000