2005 NonQualified Deferred Compensation

The federal tax legislation that adversely affects nonqualified deferred compensation (NQDC) plans has now been passed by the full House and Senate. The NQDC provisions are housed in the so-called export tax subsidy bill. The bill will be presented to the President for his signature in the next several weeks. It is expected that the President will sign the bill.

I. Summary of New Requirements

Five categories of substantive new requirements for NQDC plans may be summarized as follows:

- **Initial deferral elections into the plan**
  - Must be made not later than the close of the calendar year preceding the year in which the amount is earned
  - Exception: 30 day timeframe for first year of participation
  - Exception: with respect to "performance-based compensation," must be made at least 6 months before the end of a performance measurement period of 12 months or more (although IRS is encouraged to provide additional guidance for non-calendar fiscal year companies)
  - Must include time and form of distribution in those plans where the participant can exercise some control

- **Distributions from the plan**
  - Deferrals may not be distributed earlier than separation from service, disability, death, a time (not event) or schedule specified at the date of initial deferral, or change-in-control (CIC)
  - Exception: distributions to "key" employees *of publicly-traded companies* due to separation from service must not occur within 6 months of such separation

- **Acceleration of distributions**

  Not permitted under any circumstances except in the case of an "unforeseen emergency" (unless expected IRS guidance provides additional exceptions)

- **Subsequent elections to delay or change form of distributions from the plan**
  - May not take effect until at least 12 months after the date on which election is made, and
  - The payments subject to the election must be deferred for at least 5 years from the date they otherwise would have been made (unless due to death, disability or financial emergency), and
  - In the case of payments occurring on a specified date or pursuant to a specified schedule, subsequent election must be made not less than 12 months prior to the date of the first scheduled payment

  The IRS may provide rules permitting the election of different "actuarially equivalent" forms of payment (e.g., life annuity to 50% J&S) or regarding revising a stream of payments.

- **Funding rules**

  Plan assets that are set aside (in a trust or otherwise) are deemed to be property transferred to participants (immediately taxable unless not vested) when:

  — The funding vehicle is located outside of the United States (funding arrangements outside the United States permitted for service performed in that arrangement's jurisdiction), *or*

  — The earlier of (i) the date on which plan language first provides that assets will become "dedicated" to the provision of benefits under the plan (*including rabbi trusts subject to the claims of creditors*) in connection with a change in the employer's financial health (e.g., the so-called "springing" rabbi trust), or (ii) the date on which assets are restricted in this manner

II. Plans Impacted

The Conference Committee Agreement on the NQDC provisions is not as restrictive as either of the earlier Senate or House versions. But the legislation, *generally effective January 1, 2005*, continues to cast a wide net and include as shown below many commonly used forms of cash-based and equity-based pay:

— Elective deferral arrangements for both executives and directors are, of course, included

— SERPs, Restoration, and so-called Excess Benefit Plans offering only limited participant elections are included

— Non-discounted stock options are exempt from the new rules (unless they offer deferral rights), but cash-settled stock appreciation rights (SARs) appear to be subject to the new rules

— Equity-based deferred compensation, such as restricted stock units or deferred stock units, appear to be subject as well

— 457(f) plans of governmental and tax-exempt employers are included (457(b) and 415(m) plans are excluded)

The complexity of satisfying the new requirements will vary among the different forms of pay. If a NQDC plan violates any of the new requirements with respect to a participant, that participant's account balance or accrued benefit attributable to non-grandfathered amounts, in effect, becomes immediately taxable to the participant. Further, interest on the tax underpaid is assessed from the dates the compensation was originally earned, and a 20% penalty tax on the amount includible in income is layered on top of that.

III. Effective Dates

The new rules are effective for "amounts deferred after December 31, 2004." In the case of elective deferrals, "deferred" generally means the date the compensation otherwise would have been paid and not when the deferral election was made. However, a special rule provides that if the compensation (e.g., a 2004 bonus) is earned and vested by the end of 2004, it is considered deferred before January 1, 2005 and thus grandfathered. For example, the deferral of 2004 bonuses earned and vested by December 31, 2004 appear to be subject to the old rules even though the payment is otherwise payable to plan participants in March of 2005. In the case of non-elective plans (e.g., SERPs, Restoration, and Excess Benefit Plans), the new rules apply to post-2004 accruals.

Realizing that the broad scope of change combined with the imminent effective date will cause administrative challenges for employers, the bill instructs the IRS to identify a "transition period." During this transition period, employers will be able to communicate plan changes to participants, process new elections for 2005 compensation, and permit participants to terminate participation in the plan (because

they find the new rules to be unacceptable) or revoke outstanding prior elections made in 2004 or earlier applicable to compensation which would otherwise be paid in 2005 or later. Pre-2005 deferrals (as defined above) and earnings thereon are generally "grandfathered" and remain exempt from the new requirements. *However, if the plan is materially amended with respect to grandfathered monies after October 3, 2004 other than as permitted by the IRS, this grandfathered status is lost.*

IV. Action Steps

The nature of these tax law changes, combined with the apparently imminent arrival of stock option expensing, suggests the need for a company to evaluate it's approach to executive capital accumulation and retirement. We recommend that you evaluate your executive capital accumulation and retirement programs in light of these recent developments and frame tentative responses, but take full advantage of the soon-to-be announced IRS transition period before finalizing any restructuring of your organization's programs.

- **Immediate**
  - Inventory all executive and director supplemental pension plans, elective deferred compensation plans, equity capital accumulation plans, other contractual arrangements, and all related funding arrangements that are likely to be impacted by the new rules
  - Communicate to participants in these plans a high-level overview of the new rules and the likely impact on plan design
  - For elective deferral plans, communicate likely plan changes at a level sufficient to permit informed upcoming deferral elections by your executives and directors for 2005 compensation and fees
  - *If amending any plans, whether for related reasons or coincidentally, avoid inadvertent "un-grandfathering" of pre-2005 deferrals (Note that amendments of plans or contracts affecting the top 5 (proxy) officers or directors must be disclosed within four days in an 8-K filing*

- **Short-term**
  - Following issuance of IRS guidance, communicate the process to void outstanding deferral elections for incentives payable in 2005 or later
  - Communicate in detail new rules (in a side-by-side comparison to your plan's current rules), grandfather rules, and transition rules to affected participants
  - Design, draft and adopt new plan provisions and funding arrangements to comply with law changes
  - Where needed, implement appropriate changes to plan administration/ record keeping systems and related funding arrangements.