

Legislative Alert

October 2004

Timely information to help you operate your retirement plan more efficiently

Deferred Compensation plans face severe restrictions as a result of the American Jobs Creation Act.

Nearly every arrangement that defers the payment of compensation to a future period will be impacted by the American Jobs Creation Act of 2004 recently passed by Congress. The major exception to the types of plans affected are tax qualified retirement savings arrangements. Both broad-based plans that cover many employees and individual contracts may be subject to the change. Plans for self-employed contractors or directors will also be affected.

Plans affected may include:

- Voluntary deferred compensation plans, deferred bonus plans or individual arrangements
- Mandatory deferral plans
- Performance-based deferred compensation
- Supplemental Executive Deferred Compensation Plans (SERPs)
- Stock appreciation rights
- Phantom Stock / Restricted Stock Units
- Deferred compensation plans designed to avoid the limitations of IRC Section 457
- Deeply discounted options
- Other similar arrangements

Arrangements excluded from the change:

- Annual bonuses paid within two and one-half months of the close of the year in which they are earned
- Tax-qualified retirement plans
- Fair market value non-qualified stock options and incentive stock options
- Section 457 plans for exempt organizations and governmental units
- Bona fide vacation pay, sick pay, disability pay, compensatory time off and death benefits
- Awards of property subject to restrictions under IRC Section 83

The new legislation establishes three new sets of standards that a plan must meet to qualify for the deferral of compensation.

1. Choosing to defer compensation

- Participant elections must take place before the beginning of the year the services are performed which give rise to the compensation deferred.
- Newly eligible participants have 30 days to make any election for the applicable year.
- Performance based plans that cover 12 months or more may allow for elections not later than 6 months prior to the end of the performance period.

2. Receiving the deferred compensation

- Distributions are on account of death, disability, separation from service or at a defined point in time which may include a change in control or a unforeseeable emergency.
- Any election to defer beyond the scheduled distribution date must be made 12 months prior to the distribution date and must provide for an additional deferral of at least five years.
- Acceleration of distributions is generally prohibited.
- Changes in the form of payment (e.g. lump-sum to annuity) must comply with these rules.

3. Funding security for this type of plan

- Off-shore Rabbi trusts cannot generally be used to fund such plans.
- Arrangements to secure the assets upon the financial difficulty of the employer are prohibited.

Penalty For Violation

Unfortunately, violation of these standards (either in the language of a plan or in the plan's operation) will result in the entire balance being taxed. In addition, a 20 percent penalty tax is imposed. Finally, interest is charged as if each year's accrual under the plan had been taxed in the year earned. The consequence is that the tax liability for such failure could exceed the balance in the employee's account.

Actions

The new rules are effective for compensation earned after December 31, 2004. Vested balances in existing plans can be grandfathered but only if there are no significant amendments to that plan. The IRS is scheduled to issue guidance within the next few months to assist with implementation and the transition rule. In the interim, there are some practical steps you can take:

- Identify all of your existing deferred compensation practices.
- Consider past practices and future expectations regarding the distribution terms that could be included in a revised program.
- Continue your current election routine for 2005 deferrals. If the new law appears to change when employees will have access to their money, you should communicate that change to them.
- Consider whether other design changes should be made to these programs at the same time. It is an excellent time to take a fresh look at your executive compensation program.

For more information about these regulations or any other issues affecting your plan, please call us at 1.866.774.3578.