



CONGRESS REWRITES THE RULES ON DEFERRED COMPENSATION PLANS

The tax rules that govern non-qualified deferred compensation plans - a category that encompasses salary deferral plans, "SERPs", below-market stock options and SARs, and several other types of benefits - have been largely rewritten. Sponsors of such plans must comply with the new rules immediately, and if necessary, amend their plans by December 31, 2005.

The American Jobs Creation Act of 2004 (the "Act") substantially changes the legal requirements that apply to non-qualified deferred compensation plans. Motivated in part by reports of abusive practices involving deferred compensation at Enron



Corporation, Congress sought to stop these practices and, in doing so, has essentially rewritten the applicable tax rules. The new rules will require significant changes to the design and administrative practices of many deferred compensation plans, including certain equity compensation programs.

The new rules are already in effect, as they apply to compensation deferred on and after January 1, 2005. However, plan sponsors have until December 31, 2005 to amend their plan documents, provided that

covered plans are operated in good faith compliance with the new rules during 2005. If a deferred compensation plan fails to comply with the

new rules by the end of the year, its participants will be faced with severe tax penalties, including taxation of all amounts deferred under the non-compliant plan (immediately, or as soon as the deferred compensation vests), as well as interest on the tax "underpayment" and a 20% penalty.

The IRS has issued Notice 2005-1, which sets forth transitional rules for 2005 (discussed on page 2) and guidance on certain substantive aspects of the new rules. Additional guidance is expected later this year.



PLANS AND AGREEMENTS COVERED BY THE ACT

The Act adds new Section 409A to the Internal Revenue Code, which applies to all “non-qualified deferred compensation plans”. This term is defined very broadly, and apparently would apply to the following types of benefits, whether provided under an agreement to a single employee, or as part of a plan for two or more employees:

- Plans or agreements providing for elective deferrals of salary or bonus
- Supplemental executive retirement plans (SERPs) and other employer-funded deferred compensation programs
- Excess benefit plans
- Below market stock options and other non-qualified options
- Stock appreciation rights (SARs), if the exercise price is less than the fair market value at the date of grant
- Restricted stock and phantom stock plans
- Severance plans
- Generally, all compensation that is (1) deferred after 2004, (2) deferred before 2005 but which becomes vested on or after January 1, 2005, or (3) deferred and vested before 2004 under a plan that is substantially modified after October 3, 2004

NEW REQUIREMENTS UNDER THE ACT

The Act imposes a number of new requirements and limitations on covered plans and agreements. The following are the most important:

Distribution Limits: Under new Section 409A, deferred compensation can only be paid out upon one of the following events:

- Separation from service or, in the case of a key employee of a publicly-traded company, not earlier than six months after separation from service
- Death
- Disability (as such term is defined under the Act)
- A specified time, or pursuant to a fixed schedule, established under the plan at the time the compensation is initially deferred
- Upon a “change in control” (as defined under the Act)
- Upon the occurrence of an “unforeseeable emergency”

Accordingly, deferred compensation cannot be payable at the election of the participant, even if there is a notice or waiting period. Furthermore, distribution of deferred compensation upon a change of control will now be permitted only if the definition of “change in control” under the plan is consistent with the definition under Section 409A.





Acceleration Not Permitted: Congress was clearly concerned with the accelerated payments to Enron executives just prior to its collapse. (It was reported that Enron executives received more than \$53 million in accelerated distributions in the weeks preceding Enron's bankruptcy filing.) Accordingly, Section 409A prohibits any acceleration of the timing or schedule of payments under a deferred compensation plan, except in certain limited circumstances. Thus, so-called "haircut" provisions - under which a participant can receive an accelerated distribution of a reduced amount of deferred compensation are no longer permissible.



Deferral Elections: Generally, employee elections to defer the receipt of salary or bonuses must be made before the beginning of the year in which the related services are performed. Thus, in a calendar year plan, an employee election to defer a portion of 2006 compensation generally would have to be made on or before December 31, 2005. Under a special exception, an election to defer performance-based compensation can be made not later than six months before the end of the service period (so, by June 30th in a calendar year plan).

Furthermore, a "second election", to change the

timing or form of a distribution cannot go into effect until twelve months have elapsed, and the first payment affected by the second election cannot be made for five (5) years, or upon the death or disability of the participant or an "unforeseeable emergency". Similarly, an election to delay a scheduled distribution must be made at least twelve months before the original distribution date.

Substantial Forfeiture Risks: IRS Notice 2005-1 states that a "substantial risk of forfeiture" can consist only of:

- A requirement that the participant perform future services, or
- The occurrence of a condition relating to the purpose of the compensation, but only if the risk of forfeiture is substantial.

The second category would appear to cover such things as the attainment of company profit or stock value targets, or the achievement of individual goals such as sales targets. A non-compete covenant will *not* qualify as a substantial risk of forfeiture.

Tax Reporting: The Act requires that the employer separately report compensation deferred during the year on Form W-2. No reporting will be required for deferrals of less than \$600 in a year, and deferrals under defined benefit type programs must be reported only if and when a deferred amount is "reasonably ascertainable".

Funding: Except to the extent provided in IRS regulations (not yet issued), deferred compensation cannot be funded (i.e. by a so-called "rabbi trust") by assets held in offshore trusts, even if those assets are available to satisfy the claims of the sponsor's general creditors.



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ADMISSION INFORMATION

* Indicates admitted to practice in New York State

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EFFECTIVE DATE AND TRANSITIONAL RULES FOR 2005

The new rules under Code Section 409A apply to:

- Amounts deferred on and after January 1, 2005
- Amounts deferred before 2005, but vested on or after January 1, 2005
- Amounts deferred and vested before 2005, if the relevant deferred compensation plan or agreement is materially modified after October 3, 2004.

Accordingly, existing plans and deferrals are grandfathered only if compensation was both deferred and vested before January 1, 2005, and if the relevant plan is not materially modified after October 3, 2004.

As noted above, the new rules apply to compensation that is deferred on or after January 1, 2005. Deferred compensation plans and agreements generally must operate in "good faith compliance" with the new rules during calendar year 2005, and must be amended to fully comply with the new rules by December 31, 2005.

Under IRS Notice 2005-1, participants may make new elections as to plan distributions by December 31, 2005, without complying with the restrictions that would otherwise apply to "second elections". Similarly, participants can be allowed to drop out of deferred compensation plans and receive a distribution of previously deferred amounts, and/or to cancel deferral elections previously made, by December 31, 2005 without violating the Act.

WHAT PLAN SPONSORS MUST DO

1. *Analyze which of their plans and agreements are subject to the new rules, in light of the very broad definition of "deferred compensation" upon which the new rules turn.*
2. *Decide whether plan changes are needed. It is likely that changes will need to be made to plan provisions regarding the timing of elections, the trigger events for distributions, and plan definitions of terms such as "change of control" and "disability". Any "hair-cut" provisions in the plan must be removed or modified. Sponsors will also need to make decisions relative to amending their existing plans, or to freezing such plans and creating new plans for purposes of deferrals made on and after January 1, 2005.*
3. *Determine whether changes are needed to administrative documents, such as salary deferral elections, that will be used during 2005.*
4. *Amend non-compliant plan documents no later than December 31, 2005.*
5. *Put into place the necessary procedures to comply with the Act's tax reporting (W-2) requirements.*
6. *Coordinate with third party administrators and other service providers to make sure that the new requirements are being observed in practice.*
7. *Covered employees will have to be educated about the Act's new requirements and the effect of these requirements on elections and other participant rights under the plans.*