

## RESPONDING TO THE NEW DEFERRED COMPENSATION LEGISLATION

OCTOBER 28, 2004

The President last week signed into law the "American Jobs Creation Act of 2004" which includes comprehensive changes to the taxation of deferred compensation. The new law adds Section 409A to the Internal Revenue Code ("IRC"), which imposes current taxation and a 20% additional tax and interest on any tax underpayments on all deferred compensation arrangements that do not conform to new rules governing primarily the timing of deferred compensation elections and the payout of deferred amounts. Companies will need to begin, before year end, to gear up for compliance with the new rules, because the legislation is effective for "amounts deferred on or after January 1, 2005", meaning (a) any amounts that would have been paid in 2005 or thereafter absent the deferral, and (b) any amounts previously deferred, but not yet vested as of December 31, 2004. This memorandum offers some practical guidance as to how to proceed in the near term.

### 1. Identify Affected Plans.

The definition of a deferred compensation plan in the new law (i.e., "any plan that provides for the deferral of compensation") is not particularly helpful in determining which plans are covered. The specific exceptions to the definition, which are quite narrow (i.e., qualified plans, vacation, sick leave, compensatory time, disability pay or death benefits) raise as many questions as they answer, mostly due to the types of plans, such as equity compensation plans, stock appreciation rights and severance pay plans, that are not expressly exempted. It is clear under the law that deferred compensation plans include arrangements that cover only one person, and that the rules are not limited to employees. Thus, arrangements with directors and other non-employees will be covered by these provisions.

Generally, the test as to whether a plan of deferred compensation exists has been whether the compensation is deferred more than 2½ months beyond the taxable year of the employer during which such compensation was earned. Based on the legislation and our discussions with the Treasury Department, we have listed below our views, pending further Treasury guidance, as to whether the following types of commonly-utilized plans are deferred compensation plans for these purposes:

<u>TYPE OF PLAN</u>	<u>DEFERRED COMPENSATION PLAN?</u>
1. Qualified Defined Benefit or Defined Contribution Plan	No.
2. SERP	Generally, Yes.
3. Annual Bonus Plan (with no elective deferral feature)	Generally, No, but Yes if bonus paid out more than 2½ months after the end of the performance period.
4. Multi-year Bonus Plan	No, subject to compliance with the 2½ month rule.
5. Restricted Stock	No.
6. Restricted Stock Units	Yes, if payment of Units is deferred beyond 2½ months after vesting date(s), otherwise, probably No.
7. Stock Options granted at fair market value	No if granted at fair market value or higher.
8. Stock Options granted at a discount	Yes.
9. SARs	Yes appears to be Treasury's position but should be same answer as options (to which SARs the economic equivalent).
10. Severance Pay	Apparently Yes, although Treasury seems to be contemplating exempting broad-based severance pay plans from the application of these new rules.

## 2. Avoid Material Modifications of Grandfathered arrangements.

Amounts that have been deferred and are earned and vested prior to January 1, 2005, as described above are not subject to the new legislation unless the applicable deferred compensation plan is "materially modified" after October 3, 2004. Therefore, any proposed amendments to deferred compensation plans should be carefully reviewed to assure that they do not constitute material modifications that will cause prior deferrals to lose their grandfathered status. Modifications are "material" if they afford any additional benefit, right or feature under the deferred compensation plan, including accelerating the vesting date under the plan. Changes to deferred compensation plans that diminish benefits, rights or features are not material modifications.

### 3. Address Future Deferrals.

Deferrals occurring on or after January 1, 2005, as described above, are subject to the requirements of the new legislation. Depending on the type of deferred compensation plan, extensive changes in the plan may be required to avoid taxation (and imposition of the additional 20% tax and interest). Because of this, the law requires the Treasury to issue, within 60 days after enactment, guidance providing a limited period during which (i) participants in a deferred compensation plan can cancel their deferral elections and receive currently amounts deferred on or after January 1, 2005, and (ii) the deferred compensation plan may be amended to conform with the requirements of the legislation. Preliminary indications from Treasury are that it will provide a considerable period of time (e.g., all or substantially all of 2005) in which to address these changes.

Thus generally companies do not need to rush to complete amendments of affected existing deferred compensation plans, even with respect to 2005 deferrals, pending such guidance. That being said, companies maintaining elective deferred compensation plans do need to assure that timely deferral elections are made for 2005. The general rule is that, for income earned in 2005, the deferral election must be made by December 31, 2004. This would apply, for example, to any salary, director's fee or other deferrals of compensation that is clearly not "performance based compensation", which is not defined in the legislation.

The new law permits a deferral election relating to performance-based compensation to be made up to six months before the end of the applicable performance period. While we expect that the meaning of "performance-based compensation" will be further clarified in the pending IRS guidance, and that such term will not be limited to plans that base bonuses on solely objective criteria, it may be best to wait for the pending guidance before relying on the performance-based exception. Therefore, it at least may be prudent to plan to make 2005 bonus plan deferrals before January 1, 2005, unless it is clear that the applicable bonus plan is performance-based (e.g., a plan that meets the requirements of Section 162(m) of the IRC).

Please refer any questions you may have regarding this memorandum, or the application of the new law to your particular plans, to Ken Edgar (212-455-2560; kedgar@stblaw.com); Alvin Brown (212-455-3033; abrown@stblaw.com); or Brian Robbins (212-455-3090; brobbins@stblaw.com).

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