

Employee Benefits Update

November 2004

IMPORTANT NEW RULES FOR DEFERRED COMPENSATION ARRANGEMENTS

The American Jobs Creation Act of 2004 (the "Act"), recently passed by Congress and signed into law by President Bush, adds a new Section 409A to the Internal Revenue Code of 1986, as amended (the "Code"). Section 409A is a dramatic change in the tax rules that apply to nonqualified deferred compensation plans. These rules will impact virtually all deferred compensation plans and arrangements. Because of the short timeframe in which the Act becomes applicable, employers must act now to bring their plans and arrangements into compliance.

APPLICABILITY. The Act defines a nonqualified deferred compensation plan in very broad terms. Basically, it covers any plan or arrangement that provides for the deferral of compensation, except for qualified employer plans under the Code and any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. This broad definition conceivably applies to any deferral arrangement, including some that are not traditionally thought of as deferred compensation plans. For example, while "top hat" plans and SERPs are certainly

covered, so are bonus arrangements that defer payment beyond two and one-half months after the end of the year, severance arrangements, stock appreciation rights, phantom stock programs, and stock options issued for below fair market value. This is the case even if the plan or arrangement only covers one person. Further, the Act reaches deferred compensation plans and arrangements not only for employees but for those covering independent contractors as well.

DISTRIBUTION RULES. The Act requires that deferred compensation may not be distributed earlier than the occurrence of one of the six following events:

- Separation from service;
- Disability;
- Death;
- A specified time or fixed schedule provided under the plan;
- A change in control or ownership of the employer; and
- An unforeseen emergency.

Further, in the case of a publicly traded corporation,

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certain key employees as defined under the Code may not receive a distribution by reason of separation from service for at least six months after the separation.

ELECTION RULES. A participant must make a deferral election in the taxable year before the taxable year in which the compensation will be earned, except in the case of a participant who first becomes eligible to participate in a plan. Such a participant will have 30 days after the date he or she becomes eligible to make the deferral election.

BENEFIT ACCELERATION. The Act provides that a plan may not permit the acceleration of the time any payment under the plan is to be made, unless otherwise provided in regulations. This provision will prevent the common acceleration technique referred to as a "haircut."

FUNDING ARRANGEMENTS. The Act limits two common funding approaches. First, the use of offshore rabbi trusts is generally prevented. Second, so-called "trigger" or "springing" plans, which provide that assets become restricted to providing benefits to participants in the event of a change in the employer's financial condition or net worth, are also limited.

INCOME INCLUSION AND PENALTIES. If a plan or arrangement fails to meet the above requirements, all compensation deferred will be included in the participant's gross income. This includes the current years' deferrals, as well as all preceding year's deferrals. In addition, a penalty of 20% of the includable compensation is added, as well as interest at the underpayment rate under the Code plus 1%, on the additional tax.

REPORTING RULES. The Act requires that amounts includable in income be subject to withholding by the employer. In addition, total amounts deferred for a year are required to be reported on Form W-2 or Form 1099, as applicable, even if such amounts are not includable in income for that year.

EFFECTIVE DATE. The Act applies to amounts deferred or vested after December 31, 2004. Subject to this rule, existing arrangements would not be covered unless they are materially modified after October 3, 2004. Accordingly, it is extremely important not to amend an existing plan or arrangement until the Act's implications regarding the amendment are carefully analyzed.

ACTION STEPS. Because of the short timeframe involved, employers should act now to:

- Identify existing plans and arrangements;
- Establish an action plan;
- Develop employee communication and consent strategy;
- Evaluate securities law disclosures for public companies;
- Amend or freeze plans and arrangements and obtain board approval where needed; and
- Revise service agreements with vendors.

The foregoing is merely a summary of the complex provisions of the Act. Please contact our benefits attorneys so we can assist you with the process of bringing your deferred compensation plans and arrangements into compliance with the Act.

If you have questions regarding Employee Benefits issues, please contact our Employee Benefits attorneys:

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