

October 11, 2004

Action Steps on Deferred Compensation Legislation

On Thursday, the House approved far-reaching changes in the federal tax laws that apply to nonqualified deferred compensation plans. These changes are included in the American Jobs Creation Act of 2004 (the "Act"). The Senate is expected to pass the Act, and the President is expected to sign it into law, shortly. The deferred compensation changes will apply to amounts "deferred" (generally, earned or vested) after 2004, so employers need to quickly begin assessing the legislation's impact on their executive compensation arrangements. We attach a summary of the key portions of the Act, and describe below several important steps that employers will need to take soon.

1. Become Familiar With the Act – Employers that have not already done so will need to quickly understand the key terms of the Act. The attached summary may serve as a useful starting point.

2. Identify Affected Plans - In addition to typical elective deferral plans and defined benefit plans ("SERPs"), the Act would affect certain types of equity compensation plans and other arrangements that have not generally been considered deferred compensation plans. An employer will need to identify its plans and arrangements that could be impacted.

3. Determine Necessary Changes to Retirement Plans – An employer will need to determine the changes to its existing retirement plans that the legislation would require. The following changes would need to be made to many plans:

- "Haircut" in-service withdrawal provisions will need to be removed.
- Elections as to timing and form of payment that are tied to elections under a qualified plan (often found in SERPs) may need to be revised.
- Elections to defer "performance-based compensation" will need to be made at least six months before the end of the relevant performance period.
- Subsequent elections to defer payment of a scheduled distribution will need to provide for an additional deferral period of at least five years from the originally scheduled payment date.

- The ability of a participant to change the scheduled form of payment for a deferred amount from installments to a lump sum will need to be removed.
- Payments to "key employees" of a public company upon separation from service will need to be delayed for six months.
- The definition of "disability" may need to be revised.

4. Consider Impact on Equity Compensation Awards - In addition to the impact on retirement plans, an employer will need to consider the impact of the Act on its equity compensation practices. It appears that traditional stock options will not be subject to the new rules, while certain other forms of equity awards, such as stock appreciation rights, will be. A prohibition on deferral of equity awards was not included in the Act, but the treatment of any such deferrals under the new rules will need to be carefully analyzed.

5. Consider Amending Existing Plans v. Establishing New Plans – The Act provides that an amount deferred under a plan prior to 2005 will not be subject to the new rules unless the plan is "materially modified" after October 3, 2004. Amending a plan in accordance with IRS guidance to add the new rules for post-2004 deferrals should not jeopardize the grandfathered status of pre-2005 deferrals under the plan. Thus, a plan may be amended to essentially split the plan in two – the pre-2005 portion which would be subject to existing law, and the post-2004 portion subject to the new rules. The conference report makes clear that a violation of the new rules will only cause adverse tax results for the portion of the plan subject to the new rules.

Although it may only be a difference in form, an employer may instead choose to freeze an existing plan as of the end of 2004, and create a new plan that will apply to amounts deferred after 2004 and comply with the legislation. Either way, there will be administrative burdens and employee communication challenges.

The legislation directs the IRS to issue guidance within 60 days of enactment providing a limited period of time during which an employer may amend a plan to conform with the legislation. We understand from Treasury Department officials that plan documents will likely not actually need to be amended until some time in 2005, and that within this 60-day period they will also likely provide transition relief for deferral elections.

Because deferred compensation plans are typically exempt from most substantive requirements of ERISA, they are analyzed as contracts between the employer and plan participants. Thus, an employer should consider contractual restraints on its ability to amend an existing plan (e.g., to remove distribution rights), particularly with respect to amounts already deferred.

6. Arrange Appropriate Approvals - Whether existing plans are to be amended or new plans established, the employer's Board of Directors (or a committee with appropriate authorization) will likely need to approve the new structure in a timely manner. An employer may want to schedule a meeting of the appropriate body close to year-end for this purpose, so that as much IRS guidance as possible can be considered prior to the approval of the new structure.

7. Securities Law Issues for Public Companies - The establishment or material amendment of a deferred compensation plan by a public company will generally need to be reported to the SEC on a Form 8-K within four business days. The new plan or amendment will typically need to be included with the next Form 10-Q or Form 10-K filed by the company. The NYSE and NASDAQ corporate governance rules and shareholder approval requirements (for plans that provide for the distribution of employer securities to participants) should also be considered.

If a new plan allowing for elective deferrals is to be created, the need to register the plan with the SEC on a Form S-8 and distribute a prospectus on the plan to eligible employees should be analyzed. If elective deferrals will continue under a plan the employer has already registered with the SEC, the plan prospectus should be updated for any changes to the plan and to reflect the newly applicable tax rules.

8. Revise Election Forms and Employee Communications – Deferral election forms and other materials that are to be provided to employees at the end of 2004 should be revised to reflect any changes made to a plan. An employer should delay the delivery of revised forms and other materials until the IRS transition relief mentioned above is issued. One key area that could be impacted by the transition relief is elections to defer bonuses based on 2004 performance.

9. Amend Plan Documents – As noted above, an employer's Board of Directors (or a committee) will likely need to approve plan changes by the end of 2004. However, the IRS will likely permit employers to delay amending plan documents to bring them into compliance with the new rules for post-2004 deferrals until some date in 2005.

10. Revise Service Provider Agreements – An employer may need to revise service provider agreements (*e.g.*, rabbi trust or recordkeeping agreements) if new plans are created or existing plans are amended.