

AMERICAN JOBS CREATION ACT OF 2004

CHANGES TO THE TAX TREATMENT OF NONQUALIFIED DEFERRED COMPENSATION PLANS

IMMEDIATE ACTION MAY BE REQUIRED

The American Jobs Creation Act of 2004 includes important changes to the federal income tax treatment of most nonqualified deferred compensation arrangements. The new provisions apply to deferrals made after December 31, 2004 (and plans materially modified after October 3, 2004). Certain significant provisions of the new rules require action be taken *prior to the end of this year*. This article broadly summarizes these significant changes and suggests immediate action items.

SUMMARY OF THE CHANGES

The new provisions apply to all "nonqualified deferred compensation plans" which is broadly defined to include any nonqualified plan that provides for the deferral of compensation other than a qualified plan, any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. This includes salary and bonus deferral plans, supplemental retirement plans and plans that make up for benefits limited by qualified plan rules. The rules *also* apply to equity compensation awards including restricted stock units, SARs and nonqualified compensatory options issued with a strike price lower than fair market value.

The new rules limit the flexibility employers have had in structuring deferrals, timing distributions, accelerations and securing benefits. The consequences for failing to comply with the new rules are severe. The affected participants must immediately pay tax on the deferred amount *and* an additional 20% penalty.

Elections to defer compensation must be made, generally, prior to the commencement of the year for which the compensation will be earned. New participants have up to 30 days to make an election to defer compensation for future services. A deferral with respect to performance based compensation must be made at least 6 months prior to the end of the performance period. Special rules apply to performance-based compensation.

Deferred amounts generally must be distributed no earlier than one of the following: separation from service; a specified date (or a schedule of specified dates); death; disability; an unforeseeable emergency (only to the extent of financial hardship); or a change of control or ownership. Once made, a deferral can be further deferred, but only if (i) the plan requires that the any such election can not take effect until at least 12 months after the election is made; (ii) in the case of an election related to a payment not made as a result of the participant's disability or death, or the occurrence of an unforeseeable emergency, the plan requires that the deferral is for a period of not less than 5 years from the date the payment otherwise would have been made; and (iii) in the case of a distribution related to a specified time (or under a fixed schedule), such election may not be made less than 12 months prior to the date of the first scheduled payment.

Protecting compensation deferrals is also more difficult under the new Act. While traditional rabbi trust arrangements are still permitted, deferrals to a foreign rabbi trust are now generally taxable immediately. Further, deferred amounts will be immediately taxable if the trust arrangement provides for protection for the employee in the event of a change in the employer's financial health.

IMMEDIATE ACTION ITEMS TO CONSIDER

We recommend that our clients consider the following:

- Review compensation arrangements to identify which will be treated as deferred compensation plans under the Act.
- Plan for 2005 deferrals now. Under the Act, all deferrals must comply with the new rules, including the requirement that the deferral be made *prior* to the year for which the compensation will be earned. This means that deferrals for 2005 must be addressed this year.
- Consider adopting new plans that comply with the new Act. Because the Act now requires plan to contain certain conforming provisions, it may be more practical to adopt new plans for future years.

If you have any questions, please call Robert Finkel, Esq. at 781-622-5930 or e-mail him at rmf@mbbp.com. We would be pleased to assist you.