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Summary of H.R. 4520, Sec. 885

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H.R. 4520 has been passed by both the House and Senate and is currently pending signature by the President (the "pending law"). Section 885 of H.R. 4520 affects both elective and non-elective nonqualified deferred compensation arrangements (including individual employment contracts), and covers both executives and directors.

What types of arrangements are subject to H.R. 4520, Sec. 885? A nonqualified deferred compensation plan has been defined as a plan that provides for the deferral of compensation other than a qualified plan and a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan. This definition includes agreements or arrangements with only one person and covers employees as well as independent contractors (e.g. directors). The pending law also covers non-elective deferred compensation plans. While stock option plans that use the fair market value for the strike price are exempted, discount stock options, restricted stock plans and stock appreciation rights programs are subject to the pending law.

New Rules on Elections: Elections to defer compensation must be made prior to the beginning of the year that the subject compensation is earned. Such an election must specify both the time and method of payment. There is a 30-day exception for new participants with respect to services performed subsequent to the election. An election to defer performance-based compensation based on services performed over at least 12 months must be made at least 6 months prior to the end of the performance period. Finally, subsequent elections, with respect to amounts previously deferred, are permitted to delay a payment or to change the form of payment. With respect to the timing of a payment, the amount must be further extended for a period of at least 5 years (except in the case of disability, death, or unforeseeable emergency which may serve to accelerate a subsequent election) from the date of the first scheduled payment. A subsequent election may not take effect for at least 12 months after the date the election is made. With respect to distributions to be made at a specified date or age pursuant to plan terms, a second election must occur at least 12 months prior to the date of the first scheduled payment.

Acceleration of Distributions: Deferred compensation (both elective and non-elective), may not be distributed prior to one of the following triggering events: (1) separation from service, except for "specified employees" who must wait 6 months, or until death if earlier; (2) disability as defined by the pending law; (3) death; (4) a specified date or time under the plan (e.g. a five year minimum, or age 65); (5) a change in control (to be defined within 90 days of enactment); or (6) an unforeseeable emergency, also defined by the pending law. Please note that haircut provisions have been prohibited, e.g., plan termination, imposition of a penalty, or temporary suspension of plan participation.

What Happens if there are Plan Failures? Compensation deferred under a plan for the taxable year and all preceding years in which a plan fails to meet the requirements or fails to be operated in accordance with the pending law, is includible in gross income for the taxable year it was earned to the extent it is not subject to a "substantial risk of forfeiture." The income tax will be calculated from the time a participant first became eligible in a defective plan, or from the time the plan failed to comply, adding a late fee using the appropriate late income tax payment interest factor, plus 1%. A 20% excise penalty tax will also be assessed.

New Rules Relating to Funding: Assets set aside in offshore trusts will become taxable at the time of transfer unless substantially all of the services to which such deferred compensation relates are performed in such "foreign" jurisdiction. If a plan provides that trust assets will be restricted to the provision of benefits under the plan in connection

with a change in the employer's financial health, it will become taxable at the time of transfer. If deferred amounts become taxable because of the use of an offshore trust or because a provision makes an inappropriate connection to the employer's financial health, the tax owed will be increased by a late fee using the appropriate late income tax payment interest factor, plus 1%. A 20% excise penalty tax will also be assessed.

When Does the Law Take Effect? Amendments apply to amounts deferred (including earnings) in taxable years beginning after December 31, 2004. Any plan that is materially modified after October 3, 2004 shall be treated the same as a plan first effective on January 1, 2005. Within 60 days of enactment, guidance will be issued providing a limited period during which any plan adopted before December 31, 2004 can be amended to provide participants the option to terminate participation or to cancel an outstanding deferral election with respect to amounts deferred in taxable years beginning after December 31, 2004.

Until the Treasury issues guidance on the pending law, which the Treasury will not be required to release for 60 days after the bill is signed, it is difficult to determine with any certainty whether it is more prudent to amend and restate a plan or to freeze a plan. Based on what we know, the most conservative option is to freeze all affected plans and thus apply the pending law on a going- forward basis to such new plans, assuming a clearer distinction between new and prior deferrals and the different rules applicable to each.