

Changing the Rules

HOW THE AMERICAN JOBS CREATION ACT IMPACTS COMPENSATION

By Kenneth Tillou

CONGRESS recently enacted the American Jobs Creation Act of 2004, a lengthy tax bill intended in part to increase employment through targeted tax breaks. Though generally favorable for businesses, the Act imposes stringent new requirements on the non-qualified deferred compensation (NQDC) plans that are often provided to executive-level employees.

Effective at the start of 2005, the Act as it stands will adversely affect the tax treatment of traditional NQDC plans and a host of other compensation arrangements, including many stock options in private companies.

The new rules apply to every plan or contract that defers compensation to an employee, director or consultant beyond the close of the year in which the compensation was earned and vested. Exceptions include 401(k) and other tax-qualified retirement plans; vacation, sick and paid leave; disability and death benefits; non-discounted stock options and tax-qualified employee stock purchase (ESPP) plans.

In addition to traditional supplemental executive retirement (SERP) plans and deferred compensation plans, the new rules will impact: discounted stock options, other than those under ESPP plans; stock appreciation rights; restricted or performance shares or units, phantom equity and similar synthetic equity vehicles that allow the participant to control the timing of payment; employers of all sizes and types, including corporations, partnerships and LLCs.

Other ramifications of the Act:

- Compensation deferrals under a covered NQDC plan are ineffective unless the Act's strict documentary and operational rules are met.
- Deferral elections must be made before the year in which any of the underlying services are performed. But, if the compensation to be deferred is performance-based, the deferral election can be made as late as six months before the close of the performance period.
- Payments of deferred amounts may only be made upon death or disability, a fixed schedule, unforeseen hardship, separation from service or, to the extent provided under future regulations, a change in control. (A former employee who continues to render services as a consultant likely would not be considered separated from service.)
- Payments on account of separation from service of key employees may not begin until six months after separation.
- Early payments at the participant's election, resulting in a reduction of the payout under the so-called "haircut" provision, are barred.

- Elections to change the time or form of payment are more restricted.

If a covered NQDC plan fails to comply with the Act, affected participants are taxed on all deferred amounts once those amounts vest and must pay a 20 percent excise tax and an interest charge.

The new rules are particularly problematic for stock options issued by non-publicly traded companies because the value of the shares on the date of option grant is rarely known. If the option is issued at a discount, the excess of the option share value over the exercise price on the date of vesting will be taxable under the Act upon vesting, whether the option is exercised. This is because stock options will rarely satisfy the Act's fixed payment date requirement for effective deferral of taxation.

The Act applies to deferred amounts that first vest after 2004. For example, discount options granted in 2004 that do not vest

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until 2005 would be subject to the Act. If they vest in 2004, they aren't subject to the Act. Pre-2005 deferrals are grandfathered so long as they are not modified after October 3, 2004 and vest prior to 2005.

But watch out—amending a non-vested option to accelerate vesting into 2004 does not save the option.

The Treasury is to provide a limited remedial amendment period and other transition relief under which non-conforming NQDC plans may be modified to bring them into conformity with the Act or else terminated.

NQDC Plan sponsors should therefore promptly review their plans, taking into account whatever transition period guidance Treasury releases, and amend their plans to conform to the Act if necessary.

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