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FOULSTON SIEFKIN ISSUE ALERT

AMERICAN JOBS CREATION ACT OF 2004 AFFECTS EXECUTIVE COMPENSATION PLANS

October 28, 2004

Congress enacted the American Jobs Creation Act of 2004 (the "Act") on October 11, 2004, and the President signed the bill on October 22, 2004. The Act contains significant new rules affecting the taxation of executive compensation and nonqualified deferred compensation plans. The new rules generally are effective January 1, 2005. Following is a brief outline of these new rules. These rules are complex and will require immediate attention to ensure that amounts deferred under executive compensation and nonqualified deferred compensation plans continue not to be taxable to participants.

Application

The new rules apply to any plan or arrangement that provides for the deferral of compensation, other than a qualified plan or a bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. The new rules apply to both employer and employee deferrals and generally apply to amounts deferred or that become vested after December 31, 2004. Common examples of nonqualified deferred compensation plans include SERPs, SARs, phantom stock, excess benefit plans, and individual deferred compensation agreements such as director fee or employee bonus deferral plans. The definition is broad and open-ended, however, and may include many plans not previously considered deferred compensation plans, such as severance pay plans, split-dollar life insurance plans, PTO plans, and stock option plans with below-market exercise prices.

General Effect

- **Plan Must Satisfy New Requirements.** A plan subject to the new rules must meet certain requirements. If it does not, amounts deferred under the plan generally will be subject to immediate taxation, regardless of whether they are received by the executive or employee.

- **Interest and Penalties on Nonqualifying Deferrals.** In addition to immediate taxation, deferrals under a plan that does not satisfy the requirements will be subject to both interest and a 20% penalty.

Plan Requirements

- **Limited Distribution Events.** Under the new rules, a nonqualified deferred compensation plan may permit distributions only in the following limited circumstances:

  - Separation from service.
  - Death.
  - Disability.
  - Set time or fixed schedule specified under the plan.
  - Unforeseeable emergency.
  - Change in control.

Many of these rules are further defined for this purpose. For example, separation from service does not include the transfer between employers that are part of the same controlled group. Disability means the inability to engage in any substantial gainful activity. Amounts payable upon the occurrence of an event are not treated as amounts payable at a set time. For example, amounts payable when an individual reaches age 65 (i.e., at a set time) are permissible, but amounts payable when an individual's child begins college (i.e., upon the occurrence of an event) are not permissible. Unforeseeable emergency means a severe financial hardship resulting from illness, accident, casualty, or other extraordinary event beyond the participant's control that may not be relieved by insurance or liquidation of assets.

- **Initial Elections.** If the plan permits participant elections (i.e., deferral or payment elections), the plan must require participants to make the elections before the beginning of the year. A limited exception applies for the first year in which a participant becomes eligible to participate in the plan. The initial election in that case must be made within 30 days after the participant first becomes eligible. Additional complex rules apply for elections to defer performance-based compensation, such as bonuses.

- **Subsequent Elections.** A subsequent election to delay payment or change the form of payment must be made at least 12 months before it will take effect. In addition, any subsequent election to change the time or form of payment must generally defer payment for at least an additional 5 years. For example, if a participant elects to receive a distribution upon attaining age 65 and later desires to defer receipt of the distribution, the subsequent election must be made at least 12 months before the participant's 65th birthday (i.e., on or before the Participant's 64th birthday) and must defer receipt of the distribution at least until the participant's 70th birthday (i.e., at least an additional 5 years). As a practical matter, these new rules will prevent any changes in the time or form of distribution for participants at or near retirement.

- **Prohibition on Acceleration.** The plan must not permit the acceleration of the time or schedule of any payment under the plan. This requirement appears to apply regardless of whether the acceleration results from action of the employee or the employer or acceleration that occurs automatically under the terms of the plan (e.g., payment upon termination of the plan). For example, a plan may not permit a participant receiving installment or annuity payments to elect a faster payout. In addition, it appears the employer may not reserve the right to accelerate payment for any reason.

Information Reporting

- **W-2 Reporting.** Form W-2 reporting will be required for amounts deferred under a nonqualified deferred compensation plan. Presumably reporting will be similar to the reporting of contributions to a 401(k) plan.

Immediate Action Required

- **Review Plans and Arrangements.** Because these new rules will apply beginning January 1, 2005, you should immediately review any executive compensation or deferred compensation plans or arrangements to identify plans and arrangements that are subject to the rules and determine whether they comply with the rules.

- **Contact An Advisor.** You also should contact your benefits advisor soon to discuss the effect of these new rules on your plans and any modifications required to bring the plans into compliance.

- **Make Required Modifications.** You and your advisors should begin making any required plan modifications now, so your plans will be in compliance with the new rules by the end of this year.

These rules are complex and leave many unanswered questions. Further guidance from the Treasury Department and the IRS will be forthcoming, however, and should provide better clarity. In the meantime, should you have any questions about these new rules or their application to your executive compensation or nonqualified deferred compensation plans or arrangements, please do not hesitate to contact us.

For Further Information

Foulston Siefkin regularly counsels clients on issues relating to ERISA and Executive Compensation. If you are interested in additional information regarding these matters, please visit our website at **www.foulston.com** or if you would like to discuss specific ways in which Foulston Siefkin can help you can contact **Doug Hanisch** at (316) 291-9748, or dhanisch@foulston.com, **James Rankin** at (785) 233-3600, or jrankin@fousIton.com, or **Jason Lacey** at (316) 291-9756, or at jlacey@foulston.com.