Pay Now, Pay Later?

New deferred compensation legislation poses significant risks and penalties

by Pamela V. Rothenberg

The American Jobs Creation Act of 2004 contains provisions that drastically change the design and operation of all nonqualified deferred compensation plans and will have an immediate, material and potentially adverse impact. All executives and companies that sponsor any type of nonqualified deferred compensation arrangement should take immediate action to bring their plans, employment agreements and associated documentation into compliance to avoid significant tax penalties and other potential adverse consequences.

Affected plans include any form of compensation payable in the future, mainly to top-level employees who do not meet the requirements for a qualified plan. These include unwritten compensation arrangements or practices, even if used for only one employee. In exchange for tax breaks, companies sponsoring plans must meet stringent requirements, including complicated tests to ensure a majority of employees receive benefits and highly compensated employees are not favored.

The new legislation covers arrangements including ordinary elective deferral plans, discounted stock options, supplemental executive retirement plans, phantom stock, restricted stock, restricted stock units, 401(k) "wrap" plans, bonus and incentive deferral arrangements, severance arrangements, change-in-control arrangements with deferred compensation and 457(f) plans. The legislation affects plans regardless of the business form and applies to anyone benefiting from the plan, including independent contractors.

The legislation generally affects three aspects of nonqualified deferred compensation:

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- *Acceleration of plan payments is prohibited.* Previously, participants could receive early distributions by surrendering a small share (10 percent) of their benefits. The new law prohibits this practice. As a result, most executives must carefully plan future deferrals because they will not have the same easy access to these deferred amounts.
- *An executive can only receive benefits for certain events.* These include separation from service, death, disability, a change in control of a corporation or an extreme hardship. Certain highly paid executives in publicly traded companies must wait for distributions until six months after separation.
- *Elections must happen the year before services are performed.* If a participant wants to defer compensation in 2006, the election must be made before the end of 2005. In general, changes in the time or form of distributions may not take effect until 12 months after they are made and may require any subsequent deferrals be for at least five years.

Executives and companies should take inventory of their deferred compensation and review the terms, administration and funding of these arrangements. Changes will likely be needed to plan documents, summary plan descriptions, prospectuses, administration procedures and employment agreements. In many cases, plans will need to be amended to comply with the new legislation; in others, it may be best to cancel existing plans and provide other forms of incentive compensation. The cost of doing nothing clearly will be prohibitive. □

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