JONES WALKER

E*ZINES
October 21, 2004

Employee Benefits, ERISA & Executive Compensation
www.joneswalker.com
benefits@joneswalker.com

Admiralty & Maritime
Antitrust & Trade Regulation
Appellate Litigation
Aviation
Banking
Bankruptcy, Restructuring & Creditors-Debtors Rights
Business & Commercial Litigation
Class Action Defense
Commercial Lending & Finance
Construction
Corporate & Securities
Employee Benefits, ERISA, & Executive Compensation
Energy
Environmental & Toxic Torts
ERISA, Life, Health & Disability Insurance Litigation
Gaming
Government Relations
Health Care
Intellectual property
International
International Financial Services
Labor Relations & Employment
Mergers & Acquisitions
Products Liability
Professional Liability
Project Development & Finance
Public Finance
Real Estate: Land Use, Development & Finance
Tax (International, Federal and State)
Telecommunications & Utilities
Trusts, Estates & Personal Planning
Venture Capital & Emerging Companies
White Collar Crime

Congress Changes the Rules on Deferred Compensation

By
Edward F. Martin, John C. Blackman, Susan K. Chambers, Timothy P. Brechtel
Jones, Walker, Waechter, Poitevent, Carrère & Denègre L.L.P.

The American Jobs Creation Act just approved by Congress will make significant changes to the rules governing the income-tax treatment of deferred compensation. Many arrangements that at present allow deferral of income tax will no longer work as drafted. The Act, which the President is expected to sign, will affect compensation deferred after December 31, 2004.

The Act directs the Treasury Department within 60 days of enactment to issue guidance that will add some flesh to the bones of the Act. Even without that guidance, certain general principles are clear.

What Arrangements Are Affected? The new rules apply to numerous types of deferred compensation arrangements, including almost any plan (and even an individual employment contract) that provides for compensation earned in one year to be paid in a future year. Some types of arrangements that are covered but had not previously been a concern are:

- supplemental executive retirement plans (SERPs)
- stock appreciation rights plans
- phantom stock plans
- stock options issued at a discount.

The Act does not affect "qualified plans" under the Internal Revenue Code, and certain payroll arrangements: vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.

When Must An Employee's Deferral Election Be Made? If an arrangement allows an employee to elect to defer pay, the deferral election for a year must be made in advance of the year in which the services are performed (although special rules apply in the first year of a plan), except that in the case of performance-based compensation the election must be made no later than halfway through the year. Many arrangements already comply with this rule.

What Events Can Cause Payment of the Deferred Amount? If an employee can elect to take his deferred benefit at any time, he is in constructive receipt and is taxed regardless of whether he elects to receive the amount currently. The Act sets out rules as to how the arrangement must operate in order to avoid constructive receipt. To begin with, the arrangement cannot allow the employee to receive his vested deferred amount earlier than a specified time or times, or upon a termination of employment, disability, death, or an "unforeseeable emergency". The term "unforeseeable emergency" is defined much more narrowly than the term "hardship" that applies to 401(k) plans. "Haircut" provisions under which an employee can take a distribution at any time upon surrender of a portion of the benefit will no longer be effective to defer tax. The yet-to-be-issued guidance may also allow the arrangement to permit a change in control of the employer to trigger a benefit.

ADMIRALTY & MARITIME
ANTITRUST & TRADE REGULATION
APPELLATE LITIGATION
AVIATION
BANKING
BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
BUSINESS & COMMERCIAL LITIGATION
CLASS ACTION DEFENSE
COMMERCIAL LENDING & FINANCE
CONSTRUCTION
CORPORATE & SECURITIES
EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
ENERGY
ENVIRONMENTAL & TOXIC TORTS
ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
GAMING
GOVERNMENT RELATIONS
HEALTH CARE
INTELLECTUAL PROPERTY
INTERNATIONAL
INTERNATIONAL FINANCIAL SERVICES
LABOR RELATIONS & EMPLOYMENT
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
TAX (INTERNATIONAL, FEDERAL AND STATE)
TELECOMMUNICATIONS & UTILITIES
TRUSTS, ESTATES & PERSONAL PLANNING
VENTURE CAPITAL & EMERGING COMPANIES
WHITE COLLAR CRIME

In addition, the arrangement can not permit an employee to change the benefit payment date, or the form (such as electing between lump sum and installments), unless the election is made at least 12 months before it is effective. The new election also must postpone the benefit (or the first payment) for at least 5 years beyond the previously-elected payment date (unless the payment relates to death, disability or unforeseeable emergency). Many plans will have to be modified to comply with this requirement. The following is an example of how the new rule works:

> Suppose that under a deferred compensation plan an employee can elect to receive a benefit in the year of retirement or the following year; his initial election is to receive the benefit at retirement; and 6 months preceding retirement he elects to receive the benefit in the year following retirement. For tax purposes, the new election will be ignored, for 2 reasons: (1) because the election takes effect less than 12 months following the date it was made; and (2) because the new payment date is not at least 5 years after the previously-elected payment date. As a result, the employee is taxed on the benefit in the year of retirement.

Furthermore, if an employer's stock is publicly traded, and if the plan provides for payment of benefits upon a termination of employment, the plan must not allow payment to a key employee to be made until at least 6 months after the termination.

<u>Penalty for Non-Compliance.</u> If an arrangement, as it applies to an employee, violates these new rules at the time of deferral, the employee is immediately taxed on the amount deferred. If an amount deferred by an employee is not immediately taxed but there is a violation in a year following the deferral, the employee will be taxed on the vested amount of the deferral, as if it had been included in taxable income in the first year of deferral, plus interest. In either case an additional tax of 20% of the vested deferral is imposed.

<u>New Reporting Rules</u>. Under the Act employers will be required to report deferred compensation on IRS Form W-2, even before it is taxable. In this way the IRS will be alerted to the existence of such arrangements.

<u>Effective Date</u>. Deferrals made prior to January 1, 2005 are generally not subject to these new rules. However the new rules could apply if an existing plan is amended after October 3, 2004, in a way that undercuts the purpose of the Act. The Treasury Department will issue guidance as to what amendments can safely be made and what can't.

<u>Course of Action</u>. Employers need to determine which of their arrangements for deferred compensation will be subject to the new rules, review the terms and operations of those arrangements prior to the end of the year, and make any necessary changes in the governing documents, including any employee election forms. In some cases, it may be appropriate to freeze a plan that includes deferrals made prior to 2005, and adopt a new plan that conforms to the Act with respect to future deferrals. In particular, arrangements should be reviewed in order to:

- Determine whether the provisions that govern when the benefit can be paid comply with the Act, including the Act's definitions of disability and unforeseeable emergency;

ADMIRALTY & MARITIME
ANTITRUST & TRADE REGULATION
APPELLATE LITIGATION
AVIATION
BANKING
BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
BUSINESS & COMMERCIAL LITIGATION
CLASS ACTION DEFENSE
COMMERCIAL LENDING & FINANCE
CONSTRUCTION
CORPORATE & SECURITIES
EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
ENERGY
ENVIRONMENTAL & TOXIC TORTS
ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
GAMING
GOVERNMENT RELATIONS
HEALTH CARE
INTELLECTUAL PROPERTY
INTERNATIONAL
INTERNATIONAL FINANCIAL SERVICES
LABOR RELATIONS & EMPLOYMENT
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
TAX (INTERNATIONAL, FEDERAL AND STATE)
TELECOMMUNICATIONS & UTILITIES
TRUSTS, ESTATES & PERSONAL PLANNING
VENTURE CAPITAL & EMERGING COMPANIES
WHITE COLLAR CRIME

- Make sure that an employee's deferral election is required to be made (and is made) no later than the applicable deadline under the Act;
- Determine whether any provision in the arrangement that allows the employee to change the form or time of payment complies with the Act.

Keep in mind that elections made *this year* to defer compensation *next year* are subject to the Act.

If you would like to see the Act itself or the Joint Committee report, click on the following web sites: http://www.joneswalker.com/news/pdf/defcomptext.pdf
http://www.joneswalker.com/news/pdf/jctdefcomp.pdf

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. In addition, any of the authors of this summary will be happy to field your questions, at the following telephone numbers:

Edward F. Martin 504-582-8152
John C. Blackman 225-248-2070
Susan K. Chambers 504-582-8394
Timothy P. Brechtel 504-582-8236

ADMIRALTY & MARITIME
ANTITRUST & TRADE REGULATION
APPELLATE LITIGATION
AVIATION
BANKING
BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
BUSINESS & COMMERCIAL LITIGATION
CLASS ACTION DEFENSE
COMMERCIAL LENDING & FINANCE
CONSTRUCTION
CORPORATE & SECURITIES
EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
ENERGY
ENVIRONMENTAL & TOXIC TORTS
ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
GAMING
GOVERNMENT RELATIONS
HEALTH CARE
INTELLECTUAL PROPERTY
INTERNATIONAL
INTERNATIONAL FINANCIAL SERVICES
LABOR RELATIONS & EMPLOYMENT
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
TAX (INTERNATIONAL, FEDERAL AND STATE)
TELECOMMUNICATIONS & UTILITIES
TRUSTS, ESTATES & PERSONAL PLANNING
VENTURE CAPITAL & EMERGING COMPANIES
WHITE COLLAR CRIME

Employee Benefits, ERISA & Executive Compensation

ALTON E. BAYARD
JOHN C. BLACKMAN
TIMOTHY P. BRECHTEL
SUSAN K. CHAMBERS[1]
EDWARD F. MARTIN
MARGARET F. MURPHY
RUDOLPH R. RAMELLI
KELLY C. SIMONEAUX

---

[1] Also admitted in W. Virginia

To subscribe to other E*Zines, visit www.joneswalker.com/news/ezine.asp