

## EXECUTIVE COMPENSATION ALERT

OCTOBER 2004

### NEW NONQUALIFIED DEFERRED COMPENSATION LEGISLATION

The American Jobs Creation Act of 2004 (the "Act") adds a new Code Section 409A that will have a far-reaching impact on Nonqualified Deferred and Equity Compensation Plans and Arrangements.

#### What types of deferrals are covered by the new legislation?

Any plan or arrangement that provides for the deferral of compensation.

Examples:

- Account Balance Plans (employee deferral as well as employer wrap plans)
- Supplemental Executive Retirement Plans (SERPs)
- Stock Appreciation Rights (SARs)
- Discounted Nonqualified Stock Options
- Severance

Exceptions:

- Qualified plans, tax-deferred annuities, 457(b) plans, SEPs, SIMPLEs and qualified governmental excess benefit arrangements.

#### Distribution Requirement

Plan benefits cannot be distributed earlier than:

- separation from service
- date of disability
- death
- specified date
- change of control
- occurrence of unforeseen emergency

Haircut provisions (provisions that allow distributions with a 10% penalty) will not be allowed.

#### Acceleration of Benefit

Acceleration of time or schedule of benefits is now prohibited.

- Will not be able to change election form from installment payments to lump sum even if the 12-month rule described below is satisfied.
- Will not be able to provide the employer the discretion to accelerate benefits.

#### Election Requirement

Initial Election – The initial deferral election must be made before the beginning of the taxable year in which services are performed.

- Exception for new hires who will have 30 days.
- Performance-based compensation – election to defer may be made as late as six months prior to the end of the performance period. Compensation must be (1) contingent upon satisfaction of a pre-established performance criteria and (2) not readily ascertainable.

Subsequent Changes – Subsequent changes are permitted to the form and date of payment so long as the subsequent election is made at least 12 months prior to the date it is scheduled to commence. If the participant is electing to postpone commencement of benefits, the postponement must be at least 5 years after it was otherwise scheduled.

#### Reporting

Will now be required to report on W-2 in year of deferral. The IRS guidance may provide exception for amounts not readily ascertainable.

#### Effective Date

Effective for amounts deferred in tax years beginning after 2004. Amounts deferred in prior years are also subject to Section 409A if the plan is materially modified after October 3, 2004. Amendments that enhance or provide additional benefit to participants will be considered a material modification. Examples include acceleration of vesting, changes in earnings measurement and additions of features that will be prohibited for 2005 deferrals.

#### Transition Relief

- If elections for bonuses payable in 2005 that are dependent in all or in part on 2004 services have not been made, elections filed between now and year-end will not be in compliance. However, officials have indicated that transitional relief may be provided.
- It is likely the period for amending plans for compliance will be extended beyond January 1, 2005.
- However, employers should still make plans to revise election forms and prepare participant communications before year-end.

McAfee & Taft is planning a luncheon on October 29th to discuss these changes in greater detail. If you or any other person in your organization is interested in attending, please contact Melissa Sullivan at (405) 235-9621 for further information.

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