

American Jobs Creation Act

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Insight — 10/22/2004 12:00:00 AM

On October 22, 2004, President Bush signed the American Jobs Creation Act. This Act changes the way deferred compensation arrangements are operated starting January 1, 2005 by restricting elections to defer current income and limiting access to deferred amounts. The IRS is directed to issue guidance within 60 days of enactment that will clarify and carry out the purposes of the new law.

The American Jobs Creation Act creates a new Section 409A of the Internal Revenue Code that affects "nonqualified deferred compensation plans." The definition of this term is broad, and unless restricted by regulations will include virtually all arrangements or plans that are designed to defer taxation. The definition includes arrangements that benefit non-employees (such as directors, consultants and investment fund managers), in addition to broad-based employee plans. The only clear exceptions listed in the statute are qualified plans (such as 401(k) plans, profit sharing plans, defined benefit pension plans, 403(b) plans and 457(b) plans) and certain fringe benefits (such as vacation, sick leave, disability, or death benefit plans). In other words, this legislation will affect, among others:

- "top hat" executive retirement plans;
- phantom stock plans;
- individual employment agreements to defer compensation;
- long-term incentive and bonus programs;
- severance arrangements; and
- discounted stock options.

These arrangements must comply with the new Section 409A with respect to compensation deferred on or after January 1, 2005, meaning that 2004 bonuses paid in 2005 could be subject to the new rules. Generally, existing arrangement can be frozen as of December 31, 2004 without implicating the new requirements or be amended to apply the new rules to the future deferrals. If the new rules are broken, not only must the individual recognize the income that was intended to be deferred, but the individual will have to pay a 20% tax and interest on the amount of the denied deferral.

The new rules include the following requirements:

- Distributions may only be made for certain specified reasons. These reasons include separation from service, disability,

death, a time specified under the plan at the date of the deferral, an unforeseeable emergency, and to the extent provided under regulations (not yet issued), upon a change of control.

"Key employees" of public companies must wait an additional six months before distribution can be made on account of separation from service.

Acceleration of benefits is not allowed. In fact, the plan must specifically prohibit the acceleration of payments, except for the reasons specified above, or pursuant to IRS regulations. This provision prohibits the previously common practice of permitting early distributions subject to a discount or "haircut" as a penalty.

The initial decision to defer must be made within certain specified windows of time (generally, before the end of the year in which the income would otherwise be taxable), and elections to change the form or time of distribution first selected are also strictly limited.

Initial elections must specify the form of payment. Subsequent elections to change the form or time of distributions first selected are strictly limited, typically not becoming effective for 12 months and requiring amounts to be deferred for at least five more years.

If an arrangement provides for the protection of assets to provide deferred compensation benefits upon a change in the employer's financial health, the amounts will become subject to taxation.

These events and conditions are defined to restrict the use and availability of deferred compensation, and chances are, most plans will need to be revised in at least one respect to remain in compliance. It is critical that every employer review its existing deferred compensation and incentive arrangements to determine what steps are necessary to comply with the new provisions on or after January 1, 2005.

Please contact our Benefits Law Group if you would like assistance in determining whether your affected plans or agreements can be amended or frozen before the December 31, 2004 deadline.

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