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Congress working to limit nonqualified deferred compensation

The United States Senate on May 11, 2004 passed the Jumpstart Our Business Strength (JOBS) Act (S. 1637), which includes several provisions relating to nonqualified deferred compensation plans. Another bill, the National Employee Savings and Trust Equity Guarantee (NESTEG) Act (S. 2424), with virtually identical provisions relating to nonqualified deferred compensation is pending in the Senate. The American Jobs Creation Act of 2004 (H.R. 4520), the House's version of the JOBS Act, was introduced in the House on June 4, 2004. Both the Senate and House versions have many of the same provisions and both bills significantly restrict the design of nonqualified deferred compensation plans. While it is not certain when, or if, any of these bills will be enacted into law, similar legislation relating to nonqualified deferred compensation is thought likely to be enacted this year or next.

The JOBS Act would apply to any deferral of compensation in tax years beginning after December 31, 2004, even if under a plan of long standing. If this legislation is passed, all compensation earned and deferred after December 31, 2004 would be included in income for the first taxable year that the nonqualified deferred compensation plan fails to meet the requirements specified in the JOBS Act. Further, deferred compensation included in income under this provision would be subject to an additional 10% tax and interest computed at the underpayment rate on the tax that would have been owed had the compensation not been deferred.

The House bill does not impose a 10% penalty on deferred compensation that is included in income when the plan does not meet specific requirements. However, previously deferred compensation included in income is subject to interest at the federal underpayment rate plus one percent, which could add up to a significant penalty if compensation has been deferred for a long time. The House bill would apply to deferrals made after June 3, 2004.

Following is a summary of the other major provisions of both the Senate and House version of the JOBS Act relating to nonqualified deferred compensation.

- If a plan permits employee elective deferrals, any employee election must be made in the year preceding the year that the compensation is earned. However, in the first year of plan participation, an election may be made in the year the compensation is earned as long as the election is made for services to be performed subsequent to the election and the

election is made within 30 days from the date the employee becomes eligible to participate in the plan.

- A deferred compensation plan may permit distributions on account of: (i) separation from service (a "key employee" must wait 6 months after separation from service); (ii) disability; (iii) death; (iv) a date or schedule specified under the plan; (v) a change in ownership or control of the corporation; or (vi) an unforeseen emergency.
- A deferred compensation plan may permit acceleration of distributions on account of: (i) a change in ownership or control of the corporation (the Senate version requires insiders to wait for one year after the change in ownership); (ii) disability; or (iii) an unforeseen emergency (essentially a severe financial hardship caused by events beyond the control of participant) if the distribution is limited to the amount needed to satisfy the emergency plus a gross up for taxes. Otherwise a plan may not permit an accelerated distribution.
- A deferred compensation plan may permit an employee to change the scheduled distribution date once. Generally, any change in the payment date must be made at least 12 months prior to the original payment date and the new distribution date must be at least 5 years later than the original payment date.
- An employer's deferred compensation plan may not permit participant investment options that are broader than those offered under its tax-qualified defined contribution plan (e.g., its 401(k) plan) (if the employer has more than one plan, the comparison is to the one with the fewest options). This provision is not in the House bill.
- A deferred compensation plan may not be funded through an offshore trust.
- A deferred compensation plan may not provide that a deterioration in the financial status of the employer will trigger payment of the deferred compensation.

The JOBS Act also provides that if an employee exchanges an option to purchase employer securities, employer securities themselves or "property based on employer securities" for a right to receive future payments, the employee will have income in the year of exchange. For example, an executive who surrenders in-the-money options for the right to receive deferred compensation equal to the value of the options (a common technique in recent years) will recognize income at the time the options are surrendered. This provision applies to exchanges made after December 31, 2004 and is not in the House bill.

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June, 2004

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