SEYFARTH SHAW
MANAGEMENT ALERT

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Restrictions on Deferred Compensation Plans on the Horizon

It now appears likely that Congress will pass legislation this year restricting the use of nonqualified retirement plans (including supplemental executive retirement plans (SERPs), excess benefit plans, deferred compensation plans and rabbi trusts) by corporate executives. On May 11, the Senate passed a bill that includes limitations on nonqualified plans that are very similar to the restrictions included in a bill scheduled to be approved next week by the House Ways and Means Committee.

The main purpose of both the House and Senate bills is not related to deferred compensation, but rather is to repeal certain tax laws that have been held to be illegal trade subsidies by the World Trade Organization. As a result of the WTO decision, US exports to Europe are currently the subject of substantial, punitive tariffs. Since the administration has announced that it will comply with the WTO ruling, some version of the legislation is almost certain to be enacted, and the fact that similar restrictions on deferred compensation are included in both the House and Senate versions makes it likely that some version of these restrictions will be in the final legislation.

In light of these developments, employers should be aware of the potential new restrictions on deferred compensation and plan their compensation practices accordingly. The Senate version of the bill would apply to any compensation deferred beginning in 2005, which is the earliest date we would expect the legislation to become effective. However, the application of the effective date to fiscal year and multi-year incentive plans is still uncertain.

The principal changes on nonqualified plans in the proposed legislation are as follows:

Restrictions on Voluntary Deferral Elections

Both versions of the proposed legislation would require that voluntary deferral elections be made prior to the beginning of the year in which the compensation is earned, with an exception for the initial year. This was the position originally taken by the IRS in the 1960s, and many conservatively drafted plans still require elections to be made in the preceding year. These plans will not be affected. However, as a result of court decisions over the past 40 years, many employers and practitioners have become comfortable with more liberal election rules, particularly for bonus and incentive compensation. Plans that use these more liberal rules may need to be changed.

The proposed legislation does not distinguish between deferral of regular compensation and deferral of bonuses. Thus, an employer that maintains a nonqualified 401(k) supplemental plan must require employees to make their supplemental plan deferral elections before the beginning of the year, even though the 401(k) plan deferral elections can be changed during the year.

With regard to bonuses, many employers now permit employees to make the deferral election near the end of the year or other bonus period, when the employee has a better idea of the likely amount of his or her bonus and cash needs. Being forced to make a binding election before the beginning of the year will be a hardship on these employees. Employers who maintain this type of plan may wish to warn their employees well in advance that they will most likely have to make a decision before the end of 2004 as to how much of their bonus earned in 2005 (and paid in 2006) they wish to defer.

Distribution Restrictions

The proposed legislation would limit distributions from a nonqualified plan to those made after termination of employment, death, disability, change of control (subject to the restrictions described below), a date certain specified in advance, or financial hardship. The definition of hardship is the same that currently applies to nonqualified plans, which is much more stringent than the 401(k) definition.

The proposed legislation would eliminate so-called "haircut" clauses which permit an employee to make a withdrawal upon payment of a forfeiture, typically 10% of the amount withdrawn. In addition, the legislation would generally prohibit any acceleration of payments, apparently to preclude acceleration at the discretion of the employer. However, "scheduled in-service distributions," where the employee makes an advance election to receive a distribution to help with anticipated costs (such as college tuition) would still be permitted, but the election would have to be made when the compensation is initially deferred and could not be accelerated.

One provision of the proposed legislation would provide some clarity to the question of when an employee can change his or her election as to time and form of payment. At present the IRS ruling position is that form of payment elections must be made before the deferred compensation is earned, and cannot be changed later. Thus, for example, an employee must decide

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many years before retiring whether his entire account will be paid in a single lump sum and be fully taxable, or be paid in a series of installments. The IRS position has not been followed by the courts, and many plans permit changes up to one year before termination of employment.

The proposed legislation would codify a one-year rule, but would also provide that any change in the form of payment elected must have the effect of deferring the initial payment for at least an additional five years. Thus, an employee who had initially elected a lump sum payment upon termination of employment could not switch to installments unless the first installment were deferred for five years after termination. In addition, the Senate version would limit participants to one election.

The Shadow of Enron

In the wake of Enron and other corporate scandals, a number of provisions of the proposed legislation are designed specifically to prevent senior management from bailing out of failing companies with their deferred compensation intact. These include:

- Distributions to "key employees" (generally officers and most 1% shareholders) of a public company could not be paid until at least six months after termination of employment.
- In the Senate version, a distribution triggered by a change in control could not be made to an employee of a public company who is subject to Section 16 of the Securities Exchange Act of 1934 until 12 months after the change in control. In addition, distributions that are made within 12 months after the change in control, even if they are otherwise permitted (for example, because of a termination of employment), are subject to the 20% excise tax on golden parachute payments, regardless of amount. Moreover, if such payments would otherwise constitute taxable golden parachute payments under Section 4999 of the Internal Revenue Code because of the amount, they are taxed both under Section 4999 and under the new legislation, resulting in an effective 40% excise tax rate in addition to income taxes.
- The use of rabbi trusts that automatically convert into secular trusts upon the occurrence of criteria related to the financial health of the employer is prohibited.

Miscellaneous Restrictions

Both versions of the legislation would prohibit the use of offshore rabbi trusts, which have been used as a method of making it more difficult for creditors to reach the trust funds. The Senate (but not the House) version would limit the investment options in a nonqualified plan to the options available in the most restrictive qualified plan maintained by the employer or its affiliates, and would prohibit the deferral of compensation realized upon the exercise of a nonqualified stock option or vesting of restricted stock.

The legislation also provides that, if a nonqualified plan fails to meet any of the new requirements, all compensation previously deferred under the same plan would also be included in income, with interest from the year in which it was originally deferred. The Senate version adds a 10% penalty on prior year deferrals. Accordingly, employers who must revise their plans to comply with the new rules may wish to consider freezing the old plan and adopting a new plan to limit the retroactive exposure, depending on the final language of the legislation and any transitional rules included.

The Seyfarth Shaw LLP Employee Benefits Practice Group will continue to monitor this legislation, and we will advise our clients of further developments. Please contact the employee benefits group attorney with whom you work or any employee benefits attorney listed on the website at www.seyfarth.com if you have any questions about the proposed legislation or need assistance in reviewing your deferred compensation plans.

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