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American Jobs Creation Act of 2004 The Other Benefits & Compensation Provisions

This is the second of the Firm's Management Alerts on the American Jobs Creation Act of 2004 ("Act"), signed into law on October 22, 2004. The most significant changes made by the Act to the employee benefits arena relate to deferred compensation (view the October 22 Management Alert on the Act here). Other changes for employee benefits and executive compensation, are summarized below. While a number of these provisions are generally applicable to employer, others serve special interests or correct discrete issues and are briefly summarized.

Increased Withholding Rate for Supplemental Wage Payments

Under the Act, supplemental wage payments made on or after January 1, 2005 in excess of \$1 million will be subject to withholding at the highest marginal rate (35% for 2005). Supplemental wage payments are forms of compensation that are not paid concurrently with wages, such as bonuses, commissions, deferred compensation, severance pay, and on gain on the exercise of a non-statutory option. Presently, these payments are generally subject to a flat withholding rate of 25%. For purposes of determining the \$1 million threshold, supplemental wage payments from all controlled group members must be aggregated. The Act has no effect on the amount of tax the employee pays in any given tax year with respect to such payments, only the timing of the payment of taxes is affected.

Exclusion of Statutory Stock Options from Employment Tax Wages Confirmed

The Act amends the definition of "wages" for employment tax purposes to exempt an exercise of an incentive stock option ("ISO") or a purchase under an employee stock purchase plan ("ESPP") from FICA and FUTA taxation. It also exempts "disqualifying dispositions" — the sale of the acquired stock within the holding period — of the stock acquired by exercise of an ISO or from an ESPP from FICA and FUTA taxation. These changes codify (and clarify) prior interpretations of the law, which the IRS attempted to change by regulation in 2001. These changes are effective for exercises of statutory options on and after the October 22, 2004 date of enactment.

Deduction for Attorney's Fees in Certain Employee Benefits Lawsuits

The Act ended the "double taxation" of settlement or judgment amounts attributable to attorney's fees in employment discrimination cases (view the October 22 Management Alert on the Act here.) The Act allows an individual to make an "above the line" deduction (*i.e.*, a deduction for purposes of determining adjusted gross income) for attorneys' fees and costs paid in connection with a claim of "unlawful discrimination". While not specified, the Act appears to include claims made under ERISA section 510 which generally prohibits an employer from interfering with any rights that an employee may be entitled to under ERISA. Under current law, attorneys' fees and costs incurred by an individual are taxable to the individual and also, when paid to the attorney, taxable to the attorney. Under the Act, the amounts will only be taxable to the attorney because the individual will fully deduct the amount "above the line" to the extent included in gross income of the individual. Unlawful discrimination matters settled prior to October 22, 2004 will need to await the outcome of the cases discussed in the Management Alert referred to above.

Stock Compensation Of Insiders on Expatriation

Congress added revenue raising provisions to the Code that apply to corporate expatriations. These include an excise tax on stock compensation of insiders of expatriated corporations. This tax is payable by the employee.

A corporate expatriation is defined as a U.S. corporation reincorporating in a foreign jurisdiction and thereby replacing the U.S. parent of a multinational corporate group with a foreign parent corporation. If a corporate expatriation occurs, new Code provisions added by the Act impose on a "disqualified individual" a non-deductible excise tax equal to 15% (20% for years beginning after 2008) of the "specified stock compensation" held by the disqualified individual during the 12-month period that begins 6 months before the expatriation date. This excise tax applies only where actual stockholders would be required to recognize stock gains in the expatriation. The tax *does not* apply to any specified stock compensation that is exer-

cised, sold or otherwise paid during the 6-month period ending on the expatriation date in a transaction where income, gain or loss is recognized in full during the period.

“Disqualified individuals” affected by the new excise tax are generally those individuals who are considered insiders under section 16(a) of the Securities Exchange Act of 1934, including officers, directors and 10%-or-greater owners of private and publicly-held corporations.

“Specified stock compensation” is generally any compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder, including restricted stock, stock options, stock appreciation rights, phantom stock, and nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or a member of the expanded affiliated group). Specified stock compensation *does not* include compensation in the form of ISOs or under an ESPPs or payment from a qualified retirement plan, simplified employee pension or SIMPLE.

The excise tax is effective as of March 4, 2003, except that prior periods will not be taken into account in applying the excise tax to specified stock compensation held or cancelled during the 6-month period before the expatriation date.

Repayment of ESOP Loans for Qualifying Employer Securities by S Corporations.

Employee stock ownership plans maintained by S corporations may borrow the funds used to purchase the S corporation employer stock. Repayment of such loans is strictly regulated. In the case of a C corporation, an ESOP may use dividends on both allocated and unallocated ESOP shares to repay the loan. However, prior to the Act, an S corporation ESOP was only permitted to use a distribution made by the S corporation to its shareholders to repay a plan loan if that distribution was made with respect to unallocated shares. Under the Act, distributions with respect to S corporation ESOP shares may be used to repay a plan loan, regardless of whether the distributions were made with respect to allocated or unallocated shares. This provision is effective with respect to distributions of S corporation stock made after **December 31, 1997**.

Limited or Special Interest Provisions of the Act

- ♦ **Government Employees Can Comply with Conflict-of-Interest Requirements and Dispose of Stock.** The Act amends the ISO provisions of the Code to permit an officer or employee of the executive branch of the federal government and certain other eligible persons (as defined by Code section 1043) to dispose of stock acquired through the exercise of an ISO or an ESPP if required to do so under certain federal conflict of interest rules, without the disposition being a “disqualifying disposition” that would subject the individual to income recognition. Typically, this occurs when such person exercised statutory stock options from a previous employer and the retention of that stock causes a conflict because of current federal office or employment. This change is effective for dispositions made on and after October 22, 2004.
- ♦ **Exemption for PGA Tour’s Deferred Compensation Plan.** A last-minute addition to the Act provides a narrowly-tailored exemption for certain deferred compensation plans “established or maintained by an organization incorporated on July 2, 1974.” This exemption seemingly covers only the deferred compensation plan sponsored by the PGA Tour Inc. for its members (like Tiger Woods and Vijay Singh) who play on the professional golf tour.
- ♦ **Minimum Cost Requirements Modified for Code Section 420 Transfers of Pension Plan Assets to Retiree Medical Accounts.** Under current law, a defined

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