



BDO Seidman, LLP
Accountants and Consultants

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Subject:
Deferred
Compensation
Plan Legislation

Compensation & Benefits Tax Alert

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Details:

On October 22, 2004, President Bush signed into law the Jobs Creation Act of 2004 which has a significant impact on the taxation and structuring of deferred compensation plans and certain equity compensation plans for key executives. A key component of the legislation is the three sanctions to the executives if the plan fails to meet the new requirements. First, all deferred compensation becomes immediately taxable to the extent such compensation is vested. Second, an interest penalty is assessed for the underpayment of tax. Third, an additional 20 percent tax is imposed.

What should companies be doing? They should first review all of their compensation arrangements to determine the extent to which the new rules apply to these plans. Many plans will only need minor changes to conform to the new rules. Some plans will need to be completely revised.

The new law provides that an executive's election to defer compensation must be made before the start of the year in which the compensation will be earned. Executives will only be able to receive their deferred compensation in the event of separation from service, a fixed schedule, death or disability, change in control or under limited emergency situations. Thus, a common plan design feature called a "haircut" provision which allowed executives to get to their deferred compensation early by forfeiting a portion of their account balance will no longer be allowed.

Many plans currently use Rabbi trusts to fund the benefits of the plan. Under the new law, non-U.S. Rabbi trusts will trigger taxation when vesting occurs unless the services are being provided in the location where the trust is sited.

The new rules will include traditional deferred compensation plans and more importantly, also cover long-term equity compensation plans such as Stock Appreciation Rights plans, Restricted Stock Units, and Stock Options if the exercise price is less than the fair value of the stock on the grant date.

The new deferred compensation rules are effective for compensation deferred on or after January 1, 2005 but also apply to amounts deferred before 2005 that become vested after 2004. The IRS has been instructed to issue regulatory guidance within 60 days as relates to transition rules for allowing acceleration of benefits by December 31, 2004. Existing deferred compensation plans will not be subject to the new rules as long as the plan is not materially modified. Thus, companies may be better off creating a new separate plan for future deferrals.