

## Executive Compensation Aspects of the American Jobs Creation Act of 2004

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The American Jobs Creation Act of 2004 (effective on January 1, 2005), creating a new Section 409A of the Internal Revenue Code, provides significant changes to the tax rules for deferred compensation arrangements. Non-qualified deferred compensation arrangements, including traditional executive pay deferrals plans, bonus plans which make payments beyond 2 and 1/2 months after a performance period, executive SERPs and certain equity plans (such as, discounted stock options and cash settled stock appreciation rights), may not comply with the new rules.

Failure to comply with Section 409A makes vested deferred compensation taxable on a current basis, including an increased tax of 20% of the original deferral and earning and interest at the underpayment rate plus 1%.

For those plans subject to the Act, in order to avoid current taxation the plans must meet the following requirements of Section 409A:

- *Initial* deferral elections (including the form of payment) must be made prior to the start of the year in which compensation is earned.
  - For performance-based compensation, elections may be made up to 6 months before the end of the performance period providing the performance period is at least 12 months and the amount of the compensation must be variable and contingent on the satisfaction of pre-established organizational or individual performance criteria and not readily ascertainable at the time of the election.
- *Subsequent* deferral elections (or change in the form of payment) must be made at least 12 months prior to the date the deferred compensation would be received and extend payment for at least 5 years beyond the original payment date.
- Distributions can be made at a specific time or fixed schedule only upon termination of employment, with a 6 month delay for certain key employees defined under Section 409A.
  - Provisions may be provided for death, disability, change-in-control and unforeseeable emergency (as defined in Section 409A).
- Accelerations of payments are not permitted.

The following table highlights common plans that are exempted from or subject to Section 409A:



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Plans NOT Subject to Section 409A of Internal Revenue Code	Plans Subject to Section 409A of Internal Revenue Code
<p><u>Compensation Plans</u></p> <ul style="list-style-type: none"> <li>• <b>Employee Stock Purchase Plans</b> (satisfying Internal Revenue Code Section 423)</li> <li>• <b>Performance Shares</b> (when shares issued at grant and subject to forfeiture for not meeting performance criteria)</li> <li>• <b>Restricted Stock</b> (delivered in shares)</li> <li>• <b>Stock Options</b> (at fair market value or higher)</li> <li>• <b>Stock-settled Stock Appreciation Rights</b> (with no discount)</li> </ul> <p><u>Other Plans</u></p> <p><b>Tax qualified retirement plans</b></p>	<p><u>Compensation Plans</u></p> <ul style="list-style-type: none"> <li>• <b>Cash-settled</b> performance shares, stock appreciation rights and restricted stock units</li> <li>• <b>Discounted</b> stock options, stock units and stock appreciation rights</li> <li>• <b>Phantom Stock</b></li> <li>• <b>Stock Options with other features</b> such as "put right" or tandem with stock appreciation rights</li> <li>• <b>Deferred payments</b> after vesting of restricted stock units and performance shares</li> </ul> <p><u>Other Plans</u></p> <p><b>Severance plans</b> permitting elections between lump sum and installment payments, and plans not made in full within 75 days after the end of the year employment terminates</p>

### Stock Appreciation Rights (SAR)

The US Treasury Department issued regulations on December 20, 2004 providing a limited exemption for stock-settled SARs (an equity compensation instrument whereby an employee has the right to receive the amount of increase in the value of the company's stock for a specified period). An SAR is not considered deferred compensation if it meets the following requirements:

- The SAR can be settled only in stock.
- The exercise price can never be less than the market value of the underlying stock on the date of grant.
- The underlying stock is traded on an established securities market.
- The SAR does not include any features allowing the recipient to defer recognition of income past the date of exercise.
- The SAR does not include an agreement under which the company will repurchase the stock delivered upon exercise.

For further information, please contact us.