KIRKLAND & ELLIS LLP Alert

Employee Benefits Practice Area October 2004

This Alert highlights two important changes in the laws governing employee benefits. First, the American Jobs Creation Act of 2004 ("Act"), signed by President Bush on October 22nd, radically alters the income tax rules for deferred compensation, generally effective January 1, 2005. Second, the Department of Labor ("DOL") issued final regulations on a safe harbor for plan sponsors to select providers and investments for mandatory rollovers from qualified plans to individual retirement accounts ("IRAs"). As a result of the publication of final regulations, mandatory rollover rules are effective for qualified plan distributions beginning March 28, 2005.

NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENT CHANGES

The Act amends the Internal Revenue Code of 1986 ("Code") by adding new Section 409A, which requires immediate inclusion in income of nonqualified deferred compensation as well as the imposition of a 20% penalty unless certain requirements are met.

Arrangements Covered. The Act covers most arrangements that provide for the deferral of compensation -- whether or not voluntary -- for any individual, including employees, directors and independent contractors. Specifically, the Act covers severance and bonus plans or agreements with deferral rights, supplemental executive retirement plans, excess benefit plans, certain equity and equity-based compensation plans (including phantom stock, restricted stock units and stock appreciation rights), and Code Section 457(f) deferred compensation plans.

Certain plans are specifically excluded from Code Section 409A, such as Code Section 401(a) tax-qualified retirement plans, Code Section 457(b) deferred compensation plans, Code Section 403(b) tax-deferred annuities, IRAs and any *bona fide* vacation leave, sick leave, compensatory time, disability pay or death benefit plan.

Annual bonuses paid within 2-1/2 months after the close of the year in which services were performed are not treated as deferred compensation subject to the rules of Code Section 409A. In addition, Code Section 409A will not affect stock options granted at fair market value, incentive stock options or employee stock purchase plans.

Code Section 409A Requirements. To avoid immediate taxation of and imposition of a 20% penalty on vested amounts, a deferred compensation plan must satisfy three broad requirements:

1. *Initial Deferral Election.* A participant's initial election to defer compensation must be made by the end of the year preceding the year in which the participant performs the services for which the compensation is payable. New participants may make deferral elections within 30 days of plan eligibility. Performance-based compensation earned over a period of at least 12 months may be deferred no later than 6 months before the end of the performance period. Also, deferral elections must include an election specifying the time and form of distribution of the amount deferred, unless these terms are included in the plan document.

2. *Subsequent Deferral Election.* Any later election to delay distribution of deferred amounts must be made at least 12 months before the first payment was scheduled to begin, cannot take effect until at least 12 months after such later election is made and, except for distributions on account of death, disability (as defined in the Act) or unforeseeable emergencies (as restrictively defined in the Act), must provide for a further deferral of at least 5 years from the date the payment would have been made pursuant to the initial deferral election.

3. *Distribution Restrictions.* Generally, the time and form of distribution of the compensation deferred must be specified by the plan or the participant at the time of initial deferral, and distributions must be restricted to the earliest of: (i) separation from service (to be defined by

Treasury regulations) (or, for key employees of public companies, 6 months thereafter), (ii) disability (as defined in the Act), (iii) death, (iv) a specified time or under a fixed schedule, (v) upon a change in control of the employer, or (vi) upon the occurrence of an unforeseeable emergency (as restrictively defined in the Act).

Code Section 409A prohibits the acceleration of payments unless specifically authorized under Treasury regulations. For example, so-called "haircut" provisions that provide for immediate distribution of benefits with payment of a penalty are not permitted. Treasury regulations are expected to allow a participant to choose the form of distribution among various forms of life annuities, but, for purposes of accelerated payments, participants will not be able to elect a lump sum instead of an annuity payment. Other exceptions for distributions in the event of divorce and for small amounts upon separation from service are expected to be included in Treasury regulations.

Deferred compensation arrangements must be amended and/or drafted to comply with these new deferral and distribution rules, and to the extent applicable, to include definitions of disability, change in control, separation from service, performance-based compensation and unforeseeable emergency, all of which are provided in the Act or will be defined in Treasury regulations.

Offshore and Springing Rabbi Trusts. The Act treats the assets and earnings of most offshore rabbi trusts and rabbi trusts that restrict assets upon a change in the employer's financial health as current taxable income of the trust's beneficiaries, subject to an additional 20% penalty tax. Rabbi trusts that are funded upon a change of control are not affected, unless the funding trigger is tied to a change in the employer's financial condition.

Penalties. Noncompliance with Code Section 409A for a plan participant results in the participant being required to immediately include all vested deferrals under the plan in taxable income. Unlike some earlier versions of the law, participants who comply with the law are not affected by another's noncompliance. However, if a plan is either written or operated in a manner that does not comply with the law, all participants will be affected. Any participant subject to income tax under the law is also subject to interest on the tax that would have been due in earlier years had the compensation not been deferred (imposed at the underpayment rate plus 1%), plus an additional 20% penalty tax, which applies to all amounts included in income.

Effective Dates. Code Section 409A is applicable to compensation deferred on and after January 1, 2005. Amounts deferred prior to January 1 will generally not be subject to Code Section 409A, unless there is a material modification to the arrangement under which such deferrals were made after October 3, 2004. An amount is considered deferred prior to January 1, 2005 if it is earned and vested prior to that date. Certain transition rules will be included in Treasury regulations expected to be issued 60 days after the enactment of the law and will provide for ways to amend existing deferred compensation arrangements to allow participants to terminate participation or cancel outstanding deferral elections with respect to amounts deferred after December 31, 2004 and to conform the plan to the requirements of Code Section 409A.

Action. All sponsors of deferred compensation and bonus arrangements should begin reviewing the relevant documentation and current deferral elections for compliance with Code Section 409A to avoid immediate taxation of deferrals and the imposition of interest and penalties. Sponsors will need to evaluate whether it is preferable to amend existing plans or establish new plans. Before plans are amended, consideration should be given to the protections offered for existing deferrals under plans that have not been materially modified after October 3, 2004. Sponsors must also update administrative procedures and/or service provider arrangements and directions to reflect new plan provisions and administrative rules.

AUTOMATIC IRA ROLLOVER OF CASH-OUT DISTRIBUTIONS

As described in our April Alert, qualified plans must be amended to comply with certain mandatory automatic rollover rules. Specifically, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") requires that mandatory distributions from qualified plans made without participant consent be automatically rolled over to an IRA. EGTRRA delayed the effective date of the automatic rollover rules until the DOL issued final guidance on an employer safe harbor for selecting IRA providers and investments. Final guidance was issued in September and sets March 28, 2005 as the deadline for compliance.

In General. Automatic rollovers to IRAs are required for cash-out distributions made without participant consent in amounts of $1,001-$5,000 from tax-qualified defined benefit or defined contribution plans.

DOL Guidance. The DOL final regulations provide plan sponsors with a safe harbor for satisfying fiduciary duties under the Employee Retirement Income Security Act of 1974 ("ERISA") in connection with mandatory cash-out rollovers.

Plan sponsors that comply with the safe harbor will be deemed to satisfy their ERISA fiduciary responsibilities with respect to the selection of the IRA provider and investments, and the IRA owner will be treated as controlling the IRA from the rollover date. If a plan sponsor does not comply with the safe harbor, the terms of ERISA, as amended by EGTRRA, provide that the IRA account owner is deemed to be in control of the IRA on the earlier of the date the participant moves the money to another IRA or one year following the mandatory distribution from the plan.

Safe Harbor Conditions. The safe harbor is voluntary, but most plan sponsors will want the protection it affords under ERISA when designating an IRA provider and the initial investment of the rollovers, and to end the plan sponsor's responsibility for the IRA. To qualify for the safe harbor, six conditions must be satisfied:

1. The distribution must be an involuntary cash-out that does not exceed $5,000 (or, if the plan so provides, $5,000 plus the amount of rollover contributions previously made to the plan and earnings thereon). The final regulations extend safe harbor protection to all cash-out benefits so that a sponsor may choose to use the same cash-out distribution procedures for amounts under $1,001, even though these amounts are not required to be rolled over under EGTRRA.

2. The rollover must be made to an IRA, and the plan sponsor must enter into a written agreement with the IRA provider covering services, investment of funds and fees. The automatic rollover account is established on behalf of the plan participant, who has the right to enforce the terms of the IRA agreement. Plan sponsors need not monitor the provider's compliance with the terms of the service agreement after the money is rolled over.

3. The plan sponsor's selection of the initial investment of the IRA proceeds must be designed to minimize risk, preserve principal, provide a reasonable rate of return and maintain liquidity. The investment must be made in products offered by state or federally regulated institutions such as banks, insurance companies or mutual fund companies. Examples of acceptable investments include money market funds, interest bearing savings accounts, certificates of deposit and certain products that minimize risk, provide liquidity and seek to maintain a stable dollar value.

4. IRA and investment fees must be comparable to those charged in the market for similar products. The proposed regulations had limited fees to the income earned by the IRA, but this restriction was eliminated from the final regulations -- although it remains in the prohibited transaction class exemption for financial institutions that is discussed below.

5. Plan participants must receive a written notice of the new cash-out rollover rules, including a description of how the IRA provider and investments are selected, all applicable fees, the participant's right to enforce the IRA agreement and a contact person for additional information. The notice must make it clear that the participant can avoid an automatic rollover by instructing the plan administrator, within the prescribed time frame, exactly how the distribution should be made.

6. The selection of the IRA provider and investments must not result in a prohibited transaction. Because IRA provider and investment selections are fiduciary functions, the plan sponsor should develop an objective process to gather information necessary to assess the qualifications of IRA providers, quality of services offered and reasonableness of fees. The same process can be used in selecting the initial IRA investment.

Class Exemption. To address prohibited transaction issues faced by financial institutions that are also plan sponsors,

the DOL has issued a prohibited transaction class exemption allowing banks and other similar entities to select themselves or their affiliates as the

IRA provider and to select their own or affiliate-investment. The exemption requires compliance with the safe harbor. The fees that can be charged by financial institutions are restricted, however, and cannot exceed IRA earnings. Further, no sales commissions can be charged to the IRA.

Action. Qualified retirement plans must be amended and summary plan descriptions and distribution forms must be updated to reflect the final automatic rollover rules. IRS guidance setting deadlines for plan amendments is expected in the next few months, and will include a model amendment. In the meantime, Plan sponsors need to select IRA providers and investment vehicles, and administrative practices must be revised to provide for mandatory rollovers for distributions on and after March 28, 2005.

Plan sponsors with cash-out terms in their plans will want to finalize pending cash-out distributions before the rules are effective on March 28, 2005.

In addition, some plan sponsors may want to consider eliminating the mandatory cash-out of benefits in excess of $1,000 to avoid the automatic rollover requirements and the additional administrative expenses associated with these requirements. Any savings should be weighed against the ongoing expense of maintaining these benefits in the plan, including administrative fees and, for defined benefit plans, premiums payable to the Pension Benefit Guaranty Corporation.

Please contact the Kirkland & Ellis LLP employee benefits attorney with whom you normally work, or any of the following for assistance with compliance with these two important changes in the law.

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