AMERICAN JOBS CREATION ACT OF 2004 ("AJCA")
<u>SECTION 409A CHECKLIST</u>

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The purpose of this Checklist is to facilitate the review of nonqualified deferred compensation ("NQDC") plans and to confirm where changes will be required to amend existing plans, freeze plans and establish new plans.

AJCA Rules	**Plan Provision**	**Recommen-dation**
1. Plans Covered:		
a. Traditional NQDC Plans structured as individual account plans (<u>i.e.</u>, defined contribution plans), whether including employee and/or employer funds.		
b. NQDC Plans structured as non-account plans (<u>i.e.</u>, defined benefit NQDC Programs).		
c. NQDC Plans for Board of Directors or Independent Contractors.		
d. Ineligible Plans for Tax Exempt Entities under Section 457(f) of the Code.		
e. Nonqualified Stock Options ("NQSOs") issued at less than fair market value.		
f. Stock Appreciation Right Plans.		
g. Severance Plans (hopefully broad based programs will be excluded).		
h. Employment Agreements providing for deferrals.		
i. Foreign Pension Plans		
2. Annual deferral elections including those relating to bonuses (other than performance based bonuses meeting specified criteria) must be made prior to the end of the preceding year.		
3. Deferral elections relating to certain performance based bonuses must be made at least **6** months prior to the end of the performance period.		
4. The plan can specify a time certain for the distribution of benefits and the form of benefits. Alternatively, a plan participant can be given the right to "elect" the specified **time** for distribution of and/or the **form** of benefits, but such election must be made prior to or at the time of the participant's first deferral under the new law.		

AJCA Rules	Plan Provision	Recommen-dation
5. Absent a specified time for the distribution of benefits, payments generally cannot start prior to the earlier of death, disability or termination of employment. With respect to certain key employees of publicly traded companies, distributions may not be made prior to death or **6** months after termination of employment.		
6. Amounts payable upon the occurrence of an **"event"** are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age **65** are payable at a specified time. Amounts payable when an individual's child begins college are payable upon the occurrence of an event.		
7. A plan may provide for payment of benefits upon a change in control, but the definition of a change in control will be more restrictive under new guidelines to be published by the IRS.		
8. A participant may be granted the right to extend the time for payment of benefits for a minimum of at least **5** years beyond the date payment of benefits would otherwise commence, provided such election is made at least **12** months prior to the date that payment of benefits would otherwise commence and the election may only become effective **12** months after the election is made.		
9. The IRS intends to provide guidelines relating to the right of an employer in **very limited** circumstances to grant a participant an election to change the **form** of payment (i.e., lump sum, **5** year installment payments, **10** year installment payments, etc.). To the extent an election is permitted under IRS guidelines, such election will have to be made at least **1** year prior to the date payment of benefits would otherwise commence and the election may not be valid for at least **1** year after the election is made.		
10. Definitions requiring consideration include the following:		
a. Disability.		
b. Change in Control.		
c. Financial Health.		
d. Performance Based Compensation		
e. Unforeseeable Emergency.		
11. Tax withholding from a participant's deferred compensation account will continue to be permitted under regulations to be issued by the IRS, without the amount of the tax withholding being treated as an impermissible distribution or distribution subject to a **20%** penalty tax.		
12. Offshore trusts may not be used to fund deferred compensation obligations, except for obligations related to services performed outside of the U.S.		

AJCA Rules	Plan Provision	Recommen-dation
13. Benefit payments or trust protections may no longer be triggered by changes in the employer's financial health. Many employers established Rabbi Trusts based upon the Model Language contained in Revenue Procedure 92-64. Model Language included a provision requiring an irrevocable deposit upon a change in control to fund all benefits, which is now **impermissible**.		
14. Preliminary decision to:		
a. Amend the Plan.		
b. Terminate the Plan.		
c. Create a New Plan to protect "grandfathered" benefits.		

Footnotes:

1. **Pre-AJCA Treatment of NQDC plans**. Generally, under pre-AJCA law, if a NQDC plan is unfunded, then the compensation is generally includible in income when it is received by the plan participant or the plan participant has the right to receipt without substantial limitations or restrictions. Pre-AJCA, elections to defer compensation could generally be made at any time prior to the date the compensation becomes **payable**. In addition, payment of NQDC could be accelerated upon specified events or at any time if the early payment is subject to a penalty or other substantial limitation. Furthermore, redeferrals and changes in the form of payments generally were not significantly limited. Finally, there existed various ways to set aside the plan benefits in trust, to help ensure that plan benefits would be paid. These included offshore trusts and triggers that accelerated benefit payments or trust protections in the event the sponsoring employer experienced financial difficulties.

2. **Effect of AJCA on NQDC Plans – Sanctions**. AJCA imposes new requirements on NQDC plans and compensation deferred thereunder. The requirements apply to both the **terms** of the NQDC plan documents and the **operation** of the Plan. This means that every NQDC plan should be reviewed for form and operational compliance. If the requirements are not satisfied in form or operation, the NQDC plan participant will incur significant adverse tax consequences including current taxation on his or her deferred compensation, underpayment interest at a premium rate calculated from the deferral date(s) (or the date the deferral is no longer subject to a substantial risk of forfeiture, if later), and a **20%** non-deductible tax penalty on the deferred compensation amount. If a particular requirement affects only some of the plan participants, then current income inclusion, underpayment interest, and the non-deductible tax penalty apply only with respect to those participants.

3. **Effective Date of Changes**. The AJCA rules are effective for taxable years beginning after December 31, 2004. For purposes of the effective date, an amount is considered deferred before January 1, 2005 if the amount is **earned** and **vested** before such date. Amounts deferred in taxable years beginning before 2005 are subject to the proposal only

if the plan (or arrangement or agreement) under which the deferral is made is materially modified after **<u>October 3, 2004</u>**. The addition of any benefit, right or feature is a material modification. The exercise or reduction of any benefit, right or feature is not a material modification. Concern exists that exercise of **"discretion"** can be a modification among some practitioners.

For example, acceleration of an existing vesting schedule is a material modification. However, eliminating a distribution provision (such as an in-service distribution subject to a forfeiture (Ahaircut@) provision) would not be a material modification.

<u>Observations</u>:

a. Operating under the terms of a plan that satisfies current law and that is not materially modified after October 3, 2004, with respect to amounts deferred before 2005, is permissible. Thus, **redeferrals** with respect to amounts deferred before 2005 under a plan that is not materially modified after October 3, 2004 would not be subject to the proposal.

b. The IRS is directed to issue guidance within **60** days after the date of enactment for plans adopted by December 31, 2004, to provide a limited period in which the plans can either be amended to permit termination of participation or cancellation of outstanding deferral elections, or amended to conform to the new law. It is unclear as to whether a pre-2005 plan can be frozen as of December 31, 2004, without being subject to the new law, and a new plan placed in effect under the new law for post-2004 deferred compensation.

4. **<u>Deferral Elections</u>**. An election to defer compensation for services under a NQDC plan (including bonuses other than certain performance based bonuses) must now be made in a year prior to the year in which the related services were performed. In the case of any performance-based compensation based on services performed over a period of at least **12** months, such election may be made no later than **6** months before the end of the performance period. The IRS is directed to issue regulations defining performance-based compensation for this purpose to be compensation that is: (a) variable and contingent on the satisfaction of preestablished organizational or individual performance criteria; and (b) not readily ascertainable at the time of the election. The requirements are intended to be similar to those under Section 162(m) of the Internal Code with respect to the **$1 million** deduction limit.

5. **<u>Permissible Distribution Events</u>**. Under the new law, compensation deferred under a NQDC plan generally may not be distributed earlier than:

a. **<u>Separation from Service</u>**. The employer will be determined on a controlled group basis to preclude a participant from asserting that a separation from service has occurred upon a termination of employment with one controlled group member when being rehiring by another controlled group member. In the case of **"key employees"** of publicly-traded corporations, distributions may not be made earlier than **6** months after the date of the separation from service, except in the case of death. Key employees generally include officers having annual compensation greater than **$130,000** (adjusted for inflation and limited to **50** employees), **5%** owners, and **1%** owners having annual compensation from the employer greater than **$150,000**.

b. **Disability**. A participant is considered disabled if he or she: (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than **12** months; or (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than **12** months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

c. **Death**.

d. **A Specified Time or Pursuant to a Fixed Schedule**. Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan, and be elected at the time of deferral. Amounts payable upon the occurrence of an **event** are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age **65** are payable at a specified **"time"**. Amounts payable when an individual's child begins college are payable upon the occurrence of an **"event"**.

e. **An Unforeseeable Emergency**. An unforeseeable emergency is defined as a severe financial hardship to the participant: (i) resulting from an illness or accident of the participant, his or her spouse, or dependents; (ii) loss of the participant's property due to casualty; or (iii) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

f. **Change in Control**. Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent permitted by the IRS. Regulations defining change of control are expected within **90** days after the new law is enacted.

6. **Accelerated Distributions Generally Not Allowed**. The acceleration of distributions under a NQDC plan is not allowed, except as provided by IRS regulations. Any such

exceptions will likely be limited and narrow. Changes in the **form** of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions. It is expected that the IRS will provide **limited exceptions** to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective. For example, distributions required to comply with Federal conflict of interest requirements or a court-approved divorce settlement should be permitted.

It is expected that IRS regulations will continue to permit the withholding of an employee's share of employment taxes from the employee's interest in the NQDC plan. IRS regulations are further expected to permit automatic distributions of minimal interests in a NQDC plan upon permissible distribution events for purposes of administrative convenience (e.g., balances of **$10,000** or less will be automatically distributed, except for key employees of publicly traded companies). Other distribution rules are as follows:

a. AHaircut@ provisions, whereby a premature distribution is permitted with a forfeiture or penalty (typically, **6-10%** of the distribution) are no longer allowed.

b. Distributions made at the discretion of the employer or a third party will no longer be permitted. This is a critical issue for most NQDC plans, which traditionally retained significant discretion. However, in grandfathered plans, discretion will still be allowed.

c. Distributions that follow the participant=s election under a tax-qualified plan will no longer be permitted.

d. It currently is unclear whether the employer may terminate the NQDC plan and make payments as a result of the plan termination. IRS regulations are expected to address this.

7. **Elections Regarding Time and Form of Distribution; Changes**. The **time** and **form** of a participant=s distributions from the NQDC plan must be specified at the time of initial deferral under the new law. The NQDC plan can specify the time and form of payments that are to be made as a result of a distribution. Alternatively, participants may be allowed to elect the time and form of payment at the time of the initial deferral election.

Observation: Multiple payout events are permissible. For example, a participant could elect to receive **25%** of his or her account balance at age **50** and the remaining **75%** at age **60**. A NQDC plan could also allow a participant to elect different forms of payment for different permissible distribution events. For example, a participant could elect to receive a lump-sum distribution upon disability, but an annuity at age **65**.

The new law greatly restricts when a participant may make changes in the **time** and **form** of distributions. A NQDC plan may allow a subsequent election to delay the timing or form of distributions only if: (a) the plan requires that such election cannot be effective for at least **12** months after the date on which the election is made; (b) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of at least **5** years from the date such payment would otherwise have been made; and (c) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than **12** months prior to the date of the first scheduled payment.

The IRS intends to provide guidelines relating to the right of an employer in very limited circumstances to grant a participant an election to change the **form** of payment (i.e., lump sum, **5** year installment payments, **10** year installment payments, etc.). The IRS will also issue guidance regarding the extent to which elections to change a stream of payments are permissible.

Observation: Currently, many NQDC plans allow participants to elect the payout form and distribution commencement date in the year preceding the year in which the distribution is to be made, usually coupled with a **6**-month or **1**-year advance notice requirement. This will **no longer be permitted**.

8. **Offshore Trusts/Financial Health Triggers**. The new law restricts the use of offshore trusts as a funding mechanism for NQDC plans. Assets that are set aside directly or indirectly in an offshore trust generally are considered property transferred in connection with the performance of services and thus included in a participant's gross income as soon as the participant's interest in the assets is vested. This rule does not apply to assets located in a foreign jurisdiction if substantially all of the services related to the NQDC are performed in such foreign jurisdiction. However, Rabbi trusts are **still permitted**.

   A transfer of property in connection with the performance of services (and hence current taxation) also occurs with respect to compensation deferred under a NQDC plan if the plan provides that upon a change in the employer's **financial health**, assets will be restricted to the payment of nonqualified deferred compensation. The transfer of property occurs when the assets are so restricted or when the plan provides that assets will be restricted, whichever is earlier. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. For example, a plan provides that upon a change in the employer's financial health, a trust will become funded to the extent of all deferrals. This is impermissible, and all amounts deferred under the plan are treated as property transferred, and thus taxable.

9. **Reporting**. AJCA requires annual reporting to the IRS of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 for the year deferred even if the amount is not currently includible in income for that taxable year. The IRS is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The IRS may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable, such as with defined benefit NQDC Plans.

10. **<u>Sanctions</u>**. Significant sanctions apply for failing to operate a NQDC plan in accordance with the new law, either in **form** or in **operation**. The sanctions include current taxation of the deferred compensation benefit, a **20%** non-deductible tax penalty, and underpayment interest calculated from the deferral date(s) (or the date the deferral is no longer subject to a substantial risk of forfeiture, if later).

11. **<u>Regulations and Other Guidance</u>**. The IRS will have authority to prescribe regulations as are necessary to carry out the new NQDC plan rules, including regulations:

    a. Providing for the determination of the amount of deferral in the case of defined benefit plans (such as SERPs).

    b. Relating to changes in the ownership and control of a corporation or assets of a corporation.

    c. Exempting (from the provisions providing for transfers of property) arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

    d. Defining financial health.

    e. Disregarding a substantial risk of forfeiture. (Substantial risk of forfeitures may not be used to manipulate the timing of income inclusion.)

    f. Addressing Stock Appreciation Rights ("SARs").

    g. Addressing foreign pension plans.