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H.R. ALERT*

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American Jobs Creation Act of 2004 - Important Changes for Non-Qualified Deferred Compensation Plans

Earlier this year, both the House and the Senate approved international tax bills that included as revenue raisers new limitations applicable to the design of deferred compensation arrangements. On October 7th the Conference Committee reported out the final legislation, called the "American Jobs Creation Act of 2004." The legislation adds Code Section 409A,[1] which includes the new deferred compensation rules. The House passed the final legislation on October 7th; the Senate passed the legislation this afternoon. This memorandum summarizes the most important provisions of the legislation that impact the design of nonqualified deferred compensation plans.

1. When is the legislation effective?

The legislation applies to amounts deferred in taxable years beginning after December 31, 2004. For this purpose, an amount is considered "deferred" before January 1, 2005, only if the amount is earned and vested before that date. Accordingly, the legislation will apply to:

- The deferral of compensation payable for services to be rendered in 2005 and later;
- Amounts deferred before January 1, 2005, the payment of which is not vested before that date (for example, if an incentive bonus for services rendered in 2004 is ordinarily payable only if an executive is employed on the payment date in 2005, the deferred bonus will be subject to the new legislation because the payment of the bonus was subject to a contingency as of December 31, 2004); and
- Other benefits accrued after December 31, 2004 (for example, additional benefit accruals under a supplemental executive retirement plan).

2. Does the legislation apply to existing plans?

The legislation does not apply to amounts that are deferred before January 1, 2005, unless the plan under which the deferrals were made is materially modified after October 3, 2004. For this purpose, the addition of any benefit, right or feature will be deemed a material modification. Changes in plan terms that limit or eliminate an existing benefit, right or feature generally will not be deemed a material modification. As a result, care must be taken to identify all plan terms in effect as of October 3, 2004, and to separately account for accrued benefits or account balances as of December 31, 2004.

3. What is a nonqualified deferred compensation plan for purposes of the legislation?

The legislation broadly defines the term "plan" as any arrangement that defers the receipt of compensation, except:

- Qualified employee benefit plans;
- Eligible deferred compensation plans maintained under Code Section 457(b);
- Plans that provide for vacation pay, sick leave or disability pay; and
- Death benefit plans.

A "plan" can be a broad-based arrangement or a contract covering only one person. The term "plan" includes conventional voluntary deferral arrangements and arrangements that are funded solely by company contributions, such as supplemental executive retirement arrangements ("SERPs") and excess benefit or restoration plans. A "plan" includes arrangements maintained by a tax-exempt or governmental entity under Code Section 457(f). Based upon the definition, several types of equity based incentives are also "plans" subject to the new rules, primarily phantom stock arrangements and stock appreciation rights or SARs.

4. When must deferral elections be made?

The legislation generally codifies the existing advance ruling position of the Internal Revenue Service:

- Deferral elections generally must be made before the close of the tax year preceding the year in which the services are to be rendered and the compensation paid (for example, an election must be made not later than December 31st, with respect to services rendered and compensation to be paid in the next calendar year); and
- New participants can make elections during the 30-day period following the date of initial eligibility.

Elections to defer incentive bonuses may be made not later than six months prior to the lapse of the incentive period, provided the incentive period is not less than 12 months and the payment of the bonus and the amount of the bonus are not determinable at the time the election is made. The term "incentive bonus" will be defined by the

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* H.R. ALERT *is intended to provide late-breaking news in the employment arena.*

Internal Revenue Service in regulations; the definition will be similar to the definition of "performance-based" compensation under existing Code Section 162(m).

5. When are payment elections required:

Payment terms can be structured as follows:

- A participant can designate the time and manner of payment at the time his or her deferral election is made; or
- The plan can specify the time and manner.

In either case, payment can be made at a specified time or upon the attainment of a stated age, but <u>not</u> upon the occurrence of a particular event. As a result, short-term deferrals (for example, savings for college tuition) continue to be permitted, <u>provided</u> the payment election or plan terms are properly drafted.

If the plan sponsor is a public company, payment to "key employees" cannot be made during the six-month period following the termination of employment.

6. Can the time of payment be modified after the deferral period begins?

Yes. A plan can permit a participant to designate another payment date, <u>provided</u> all of the following conditions are satisfied:

- The election is not effective during the 12-month period after receipt by the company;
- The election must be received at least 12 months prior to the date on which distributions are scheduled to commence; and
- The election must operate to postpone payments for at least five years from their scheduled distribution date.

7. Can the method of payment be modified after the deferral period begins?

Yes. A plan can permit a participant to designate another method of payment (for example, to elect installment payments instead of a single-sum), provided:

- The election is not effective during the 12-month period after receipt by the company;
- The election must be received at least 12 months prior to the date on which distributions are scheduled to commence; and
- The election does not accelerate the payment of benefits in any manner (for example, changing an existing election from installment payments to a single sum).

The Internal Revenue Service is required to promulgate regulations providing additional guidance in this area.

8. Are in-service withdrawals permitted?

Yes. The legislation expressly permits in-service withdrawals in the event of:

- Disability; and
- Unforeseeable financial hardship.

Both of these terms are expressly defined in the legislation. It is not certain, however, whether some form of payment election can be made when a disability or hardship actually occurs or whether the payment election must be made earlier, at the time of deferral.

The Internal Revenue Service has been instructed to issue regulations about the distribution of benefits in the event of a change in control. For this purpose, the term "change in control" is likely to have the definition used under Code Section 280G.

9. What is the penalty for failure to comply?

If a deferred compensation plan fails to satisfy the new requirements (a plan design failure) or the plan in operation fails to comply with its terms (an administrative or operational failure), <u>all deferred compensation of all affected participants</u> under the plan, including interest and earnings, will be included in gross income. In addition:

- An additional 20% tax will be imposed on the amount includable in income; and
- Interest calculated at the underpayment rate plus 1% will be due, measured from the date on which the compensation was first deferred or the deferred compensation became nonforfeitable.

An "affected participant" is defined as a participant or group of participants with respect to whom the failure relates.

10. When will additional guidance be issued?

Some guidance has been issued; the Joint Explanatory Statement of the Committee of the Conference was released on October 7, 2004, and includes the legislative history of the legislation. The legislation also directs the Internal Revenue Service to promulgate regulations not later than 60 days after enactment. These regulations will provide more information about the effective date provisions and permit the "unwinding" of arrangements entered into before December 31, 2004, with respect to deferrals to be made after that date (i.e., deferral elections already made for compensation payable in 2005). Additional regulations are

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anticipated, but there is no timetable for the promulgation of these regulations

11. How should companies begin to plan?

A number of actions may be appropriate now, pending the release of Internal Revenue Service regulations:

- Identify all existing "plans" and ensure that no changes are inadvertently made to the plans or to deferrals made under the plans;
- If a plan was registered with the Securities and Exchange Commission, consider the modification of the existing prospectus to ensure that the new rules are adequately disclosed before elections to defer compensation payable in 2005 are solicited;
- Ensure that participant communications are revised to adequately describe the new rules;
- Ensure that existing recordkeeping systems will separately account for deferrals or accruals made before January 1, 2005, and deferrals or accruals made after that date; and
- Consider obtaining a delegation of authority from the board of directors, if necessary to adopt, modify or amend plan terms to reflect the new tax rules before the next regularly scheduled board meeting.

We will be providing additional information concerning deferred compensation as it becomes available. This memorandum provides information about new developments and is not intended as legal advice or as an opinion on specific facts. If you have any questions about the new requirements, please feel free to contact Jane Armstrong (504-584-9244), Debbie Dees (601-360-9334), Seale Pylate (601-360-9342) or Zenel Doucet (504-584-9262).

The Fifth Circuit Court of Appeal Revisits the Cat's Paw Analysis in the Context of Employment Discrimination Claims

In *Roberson v. Alltel Information Systems*, 373 F.3d 647 (5th Cir. 2004), the Fifth Circuit was faced with an employment discrimination suit filed by a twenty-year employee against Alltel. The lawsuit was predicated on Louis Roberson's termination as part of a reduction in force ("RIF") at the company. Roberson contended that his employment severance was based on age and race in violation of Title VII, 42 USC § 1981 and the Age Discrimination in Employment Act. Roberson also alleged retaliation on the grounds that his RIF occurred after he had complained about workplace discrimination.

Prior to Roberson's RIF, he had complained to Alltel on multiple occasions about alleged discriminatory treatment. He had also complained that he suffered adverse treatment because of complaints he had made about workplace discrimination. In the district court, Alltel filed a motion for summary judgment, stating that it had terminated Roberson as part of a larger reduction in force. Alltel further stated that any adverse employment actions suffered by Roberson were the result of legitimate non-discriminatory reasons and not retaliatory animus. The district court granted summary judgment in favor of Alltel dismissing Roberson's claims.

On appeal, the Fifth Circuit affirmed the district court's granting of summary judgment. In seeking reversal of the Fifth Circuit's ruling, Roberson contended on appeal that the district court should have invoked a "cat's paw" analysis to Alltel's reduction in force decision.

To invoke the "cat's paw" analysis in an employment discrimination case, a plaintiff must submit evidence sufficient to establish two discreet conditions. First, a plaintiff must prove that a coworker exhibited discriminatory animus. Second, a plaintiff must prove that the same coworker "possessed leverage or exerted influence, over the titular decision maker". 373 F.3d at 653. In noting the conditions necessary for a court to invoke a cat's paw analysis, the Fifth Circuit reiterated that a plaintiff must offer more than mere conclusory allegations that a coworker exhibited discriminatory animus to establish that the coworker may have influenced the decision maker. After noting the requirements necessary for application of the cat's paw analysis, the Fifth Circuit rejected its application, emphasizing that such an analysis is appropriate only if there is sufficient evidence to establish that a coworker did in fact exhibit discriminatory animus and that the same coworker possessed leverage or exerted influence over the decision maker. The circuit court also reiterated that Roberson's mere subjective belief that he was not selected for certain positions based on his race or age were simply insufficient to raise an inference of defendant's alleged discriminatory intent. 373 F.3d at 654.

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Employer Practice Tip: In light of the cat's paw analysis which now can be applied in employment discrimination cases in the Fifth Circuit, employers should be mindful of not allowing anyone previously accused or involved in discrimination allegations or complaints of an employee to have any type of input or influence on any employment decision involving that employee. Allowing any employee who has been alleged to have exhibited discriminatory animus to then influence a decision maker could result in application of the cat's paw analysis and allow imputation of alleged discriminatory animus to an otherwise fair employment decision.

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Inquiries concerning topics addressed in the *H.R. Alert* may be directed to Nan Alessandra, Jane Armstrong, Kim Boyle, or David Korn. Your comments, questions, and suggestions are encouraged.

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MARK YOUR CALENDARS

New Orleans Employment Law Seminar
"Best Practices in Key Areas of Employment"
Thursday, November 4, 2004
Wyndham Canal Place

Our guest speakers will be Keith Hill, EEOC Regional Attorney, who will address key developments of EEOC and Dr. John Thompson, Chief of Adult Psychiatry at Tulane Medical Center, who will address avoiding workplace violence.

For further information, please E-mail Nan Alessandra at alessann@phelps.com