

CLIENT ALERT

AMERICAN JOBS CREATION ACT OF 2004

The American Jobs Creation Act of 2004 (the "Act") was signed by the President on October 22, 2004. The Act makes significant changes to the rules regarding nonqualified deferred compensation arrangements and to the rules regarding S corporation ESOPs.

Nonqualified Deferred Compensation Arrangements

The Act imposes certain restrictions on nonqualified deferred compensation arrangements and applies to amounts deferred after December 31, 2004 and earnings thereon. For amounts deferred prior to January 1, 2005, the Act applies to plans that are materially modified after October 3, 2004. The Act's broad definition of what constitutes "nonqualified deferred compensation" means that it will affect many equity-based deferred compensation arrangements, including stock appreciation rights, phantom stock, and restricted stock grants. The Act does not apply, however, to qualified incentive stock options or nonqualified stock options with an exercise price that is not less than fair market value on the date of the grant.

New Rules The Act provides that all amounts deferred for a taxable year and all preceding taxable years are includible in the employee's gross income to the extent these amounts are (i) not subject to a substantial risk of forfeiture, (ii) not previously included in gross income, and (iii) the plan document does not contain the provisions specified by the Act for deferral elections, distributions and acceleration of benefits. Violations of the new rules under the Act will give rise to immediate taxation of the deferred compensation (including interest), plus a 20% penalty tax, and withholding tax penalties.

Generally, the Act requires that elections to defer compensation must be made no later than the last day of the year before the year in which the deferred compensation is earned. Limited exceptions

exist for the first year of participation and for "performance-based" deferred compensation.

Under the Act, compensation deferred under a plan after December 31, 2004 cannot be paid earlier than (i) the date specified in the election or pursuant to a fixed schedule, (ii) upon the participant's death, disability or separation from service, or (iii) upon a change of control or unforeseeable emergency (the latter two events to be defined in regulations). If a plan permits a distribution for any other event, income inclusion will occur. For example, distributions made when an employee purchases a home or when an employee's child enters college are impermissible events and therefore will cause income inclusion.

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Once an election has been made, subsequent amendments to accelerate distributions are not generally permitted. Subsequent elections changing the timing or form of distributions may be made, but are subject to significant restrictions.

•**Grandfathering** Deferrals made prior to December 31, 2004 are grandfathered. However, it is not clear exactly when an amount is considered deferred for this purpose as the legislative history of the Act indicates that vesting will be required in order to qualify for grandfathering. Further, any “material modifications” of an existing plan risk losing grandfather status.

•**What to do now** Treasury is required to issue guidance on the Act before the end of December. The guidance will clarify what actions need to be taken to amend existing plans. In the meantime, be aware that the Act applies to all deferred compensation plans, including contracts and other arrangements that benefit a single individual, and

that the new rules will likely extend to many equity based arrangements. We recommend that employers review the Treasury guidance before taking action to amend their existing plans so as to minimize the risk of losing grandfathered status.

S Corporation ESOPs

Under prior law, an ESOP owning stock of an S corporation could be treated as violating plan qualification requirements and engaging in a taxable prohibited transaction if distributions that were paid on allocated shares of company stock held by the ESOP were used to make payments on an acquisition loan. Under the Act, distributions paid on a participant’s allocated shares of company stock and used to pay the ESOP’s acquisition debt will not be subject to prohibited transactions tax, as long as the plan provides that company stock with a fair market value of not less than the amount of the distributions is allocated to the participant’s account.

The changes made by the Act are retroactively effective for distributions made on S corporation stock after December 31, 1997, and serve to equalize the treatment of C corporation dividends and S corporation distributions under the Internal Revenue Code. Since S distributions do not count as annual additions for purposes of determining the Code’s contribution or allocation limits, S corporation ESOP sponsors will now be able to use S distributions to increase their ESOP debt service payments and accelerate the acquisition loan payoff period.

▪ *If you have questions about the effect of the Act on your deferred compensation arrangements, or on your ability to use S distributions to repay your ESOP’s acquisition debt, contact Rob Edwards in our Providence office (401-632-0480) or Mark Kossow in our Philadelphia office (215-508-1500).*



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