

*Benefits Update**New Legislation and How It May Impact You*

Recently, President Bush signed into law the American Jobs Creation Act of 2004 and the Working Families Tax Relief Act of 2004. The purpose of this Benefits Update is to provide you with some basic information regarding the potential impact these laws may have on your employee benefit plans.

### **American Jobs Creation Act of 2004 (the "Jobs Act")**

On October 22, 2004, President Bush signed the Jobs Act into law. The Jobs Act adds Section 409A to the Internal Revenue Code (the "Code"), providing specific rules governing non-qualified deferred compensation arrangements. A few things to know about the new rules:

#### **Non-Qualified Deferred Compensation Plan**

- A. New Section 409A is very broad in its scope. It applies to *any* plan or arrangement (including an individual agreement) that provides for the deferral of compensation.
- B. Section 409A does not apply to:
  - tax-qualified retirement plans (Section 401(a) qualified retirement plans, Section 457(b) plans of tax-exempt organizations and governmental units, tax-deferred annuity plans under Section 403(a) and (b), SEPs, SIMPLEs and governmental excess benefit arrangements under Section 415(m)); or
  - bona fide vacation, sickness or disability, and death benefit plans.
- C. Subject to regulations, Section 409A is not intended to apply to:
  - stock option grants within an exercise price that is not less than fair market value on the date grant;

- benefits subject to a substantial risk of forfeiture; or
- bonuses paid within 2-1/2 months after the close of the taxable year.

#### **Affected Arrangements**

See Appendix A, attached.

**Impact.** The current or former employee who will receive deferred compensation under a plan that does not comply with Code Section 409A will be taxed on the deferred compensation immediately plus a 20% excise tax, plus interest from the date of deferral. This is intended to be punitive, to force compliance with Code Section 409A.

**Rules.** To avoid adverse tax treatment, deferred compensation arrangements must comply with new rules regarding:

- timing of deferral elections
- changes made in the timing or form of a distribution election subsequent to initial deferral
- permissible distribution events
- funding (off-shore rabbi trusts and provisions protecting trust assets at the onset of an adverse financial condition are prohibited)

#### **Effective Date and Grandfathered Arrangements**

New Section 409A applies to compensation deferred after December 31, 2004 or pursuant to a plan adopted or materially modified after October 3, 2004. Deferred compensation earned but unvested as of that date will also be subject to the new rules.

Arrangements in effect prior to October 4, 2004 that are not materially modified after that date will continue to be subject to pre-existing tax rules to the extent that deferred compensation is earned and vested as of December 31, 2004. However, based on comments

by William Sweetnam (Benefits Tax Counsel, Department of the Treasury) in October, there is likely to be enhanced review and enforcement of pre-existing rules with respect to existing arrangements.

## IRS Guidance

The IRS is required to issue transition guidance on or before December 22, 2004. A transition period extending into 2005 is required by the Jobs Act.

On a conference call hosted by the American Benefits Council, the IRS suggested, informally, that employers should continue to act in the normal course and wait for the guidance to be issued before taking any substantive actions.

## Working Families Tax Relief Act of 2004 (the "Families Act")

On October 4, 2004, President Bush signed the Families Act into law. Among the many changes, the Families Act provides a new definition of "dependent" in the Internal Revenue Code which will take effect on December 31, 2004. The goal of the Families Act is to provide certain tax breaks for working families and businesses.

The change in the definition of "dependent" created unintended consequences on certain benefit

arrangements. For example, if a person is covered as a dependent under a health plan, but does not meet the new definition of "dependent," benefits provided under the plan would be imputed as income to the employee.

This change also impacts 401(k) and Code Section 457(b) plans that offer hardship withdrawals. The plan would not be permitted to allow a hardship distribution for certain circumstances that would have been permissible prior to the change.

On December 6, 2004, the IRS issued Notice 2004-79. The notice provides that the IRS intends to amend the Treasury regulations for health plans that were impacted by the changes made by the Families Act and that employers may rely on the notice until the IRS amends the regulations.

Unless an employer's health plan specifically references Section 152 of the Code, employers will not need to amend the definition of dependent in their health plans.

The IRS's actions should fix the problem with respect to all plans other than dependent care account plans (Section 129 plans), and the hardship provisions of 401(k) plans and 457 plans.

Legislation has also been introduced in Congress that would fix these "dependent" definition issues.

## Contact Us

This notice does not and is not intended to cover all provisions of the new tax laws, or to provide guidance with respect to any individual circumstance or plan. This notice is to let you know that there have been changes that are likely to affect a large number of plans, including virtually every plan that provides for deferred compensation and that we are available to discuss the impact these changes may have on your benefit arrangements. A fair amount of work may need to be done in the first quarter of next year to bring your plans into compliance with these new rules. **Please contact us as early as possible if you would like us to work on these matters.**

Please call your regular Firm contact or any of the Jenner & Block attorneys listed below.

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*This Benefits Update is for information purposes only. It is not meant to be a comprehensive description of the applicable tax rules and should not be construed as legal or tax advice.*

## Appendix A

**Arrangements that may be affected by new Code Section 409A include (but are not limited to):**

- supplemental executive retirement plans
- salary and bonus deferral arrangements
- deferred commission arrangements
- excess benefit plans
- Code Section 457(f) plans (ineligible plans for government and tax exempt entities)
- severance pay plans that have the effect of deferring compensation
- deferred compensation plans for directors and non-employees,
- certain equity plans (stock appreciation rights, phantom stocks plans, restricted stock, discounted option grants)
- litigation settlements granting deferred compensation
- any other arrangement or plan that has the effect of deferring compensation relating to one taxable year into a subsequent taxable year (other than an amount paid within 2 1/2 months of the end of the year to which services relate).