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## Money & Investing Strings Attached

Ashlea Ebeling, 12.27.04

### Deferred compensation isn't gone. But Congress has taken all the fun out of it.

During Christmases past, many executives merrily deferred receipt of their big year-end bonuses. It was an easy call. The funds could grow tax-deferred until an executive retired or left the company. And if he wanted them sooner for any reason at all, he could tap them simply by paying regular taxes and a company-set penalty (or "haircut") of as little as 2%.

Now Congress has played Grinch. Executives who cash in future deferrals early (except for a few specified reasons) will owe a hefty 20% tax penalty--twice that paid by folks taking early distributions from Individual Retirement Accounts or 401(k)s. The penalty is part of a new section of the tax code clamping down on salary and bonus deferrals, executive retirement and benefit plans, severance packages, discounted stock options and even stock appreciation rights. The section also puts executives' deferred money at greater risk if a company tanks and forces employees to decide earlier whether to



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defer future pay.

The provisions, part of the 650-page corporate tax bill enacted in October, represent an about-face by Congress. Since 1978 it had barred the Internal Revenue Service from issuing regulations covering "nonqualified" deferred comp. That gave employers lots of latitude to design flexible plans. The new law, by contrast, dictates what is and isn't allowed and orders the Treasury and IRS to write regulations.

Under this new regime, mistakes are punished harshly. If the IRS later determines an employee's original deferral violated some new rule (say, just missing a deadline for deciding to defer pay), he'll have to pay regular taxes and the 20% penalty tax on the whole balance (including earnings). Plus, he'll be charged interest, accrued at 1% above the normal IRS rate, on the taxes that would have been due originally on the wrongly deferred pay. Mary Hevener, a Baker & McKenzie lawyer who works on executive compensation, figures that if wrongly deferred money sits for 15 years before the mistake is caught, the taxes, penalties and interest could consume the whole account. Gotcha!

Deferring taxes will still appeal to many of the well paid. But others, particularly those unsure of their company's future or their own, will be better off taking their money now, paying ordinary taxes at today's comparatively low rates and then investing what's left on their own. This way capital gains and dividends will be taxed at a top rate of 15%, whereas the investment return on deferred pay is all eventually taxed as ordinary income at a top rate of 35%.

The new rules shouldn't affect a 2004 bonus paid in 2005--assuming, that is, it's part of a grandfathered plan that doesn't run afoul of tricky grandfathering rules. But the changes are already complicating executives' lives. Some employees may even have to decide by Dec. 31, 2004 whether to defer bonuses to be earned in 2005 and paid in 2006--absurd, considering that Congress didn't require the Treasury and the IRS to issue preliminary guidance until Dec. 21.

### Early deadlines

In the past companies typically didn't require employees to decide until, say, October whether they would take or defer a bonus that would be awarded in December and paid the following month. Some companies even allowed employees to decide just a few days before an award whether to defer. Deciding that late was risky, because the whole pretext for putting off taxes is the notion that the exec doesn't have a right to receive the cash at the time it's deferred.

Under the new regime you must make the deferral election more than

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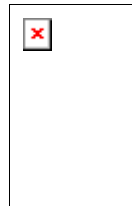
 

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a year in advance. For example, by the end of 2005 you have to decide what you're doing with a bonus you'd get in 2007 for work done in 2006. "It's like taking a shot in the dark," says employee benefits lawyer Mark Bokert of Davis & Gilbert in New York City.

One exception: The law allows six months extra for decisions on "performance-based" pay. Lawyers are hoping the Treasury will define this broadly enough to cover most long-term incentive plans. They're also lobbying for a reprieve allowing one more year of late elections, so no employee will have to make a decision by the end of this month.

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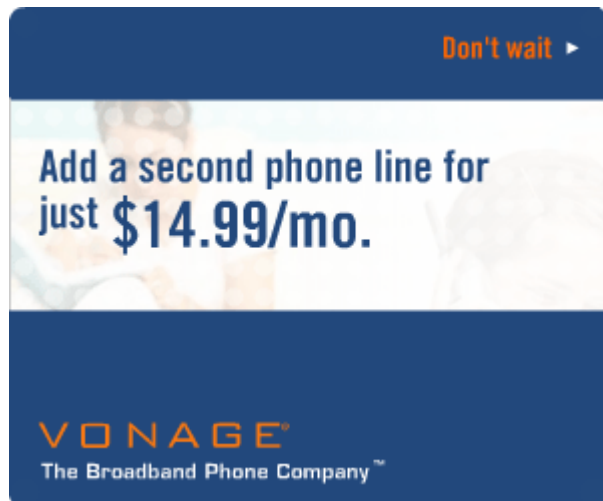
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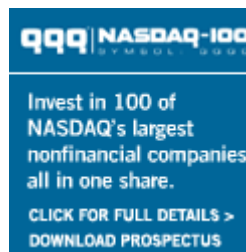


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## Money & Investing

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Ashlea Ebeling, 12.27.04

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### Limited distributions

You (or your heirs) will be able to withdraw money without penalty only in six cases: on a date you specify on joining the plan; when you leave the company; at your death; upon disability; at a change in corporate control; or in an emergency. The regulations will have to define those terms. What's an emergency? And does a small business owner who takes a payout when he retires flunk the "separation of service" test if he drops by the office regularly to monitor how his kids are running the show? It's hard to know, says Phoenix CPA Edward Zollars.

### Lump sum lock-in

Employees have also lost flexibility when it comes to choosing how they want to withdraw their money. You used to be able to choose between a lump sum or annuity payouts shortly before taking the money. The new rules make you lock in that choice years earlier, when you choose to defer. There is a chance to reconsider--you can change your mind about the distribution form if you do so at least 12 months before the set distribution date and simultaneously delay that date by at least five years.

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## Less creditor protection

The risk in a deferral is that the money isn't protected from company creditors the way employer contributions to a 401(k) are. But over the years the lawyers had developed creative ways to protect executives' stakes. One method was to put the funds in "rabbi trusts"--so called because a synagogue was the first to get one blessed by the IRS--that were protected, to some degree, from a company's creditors.

The new rules limit the protection these trusts can provide and ban certain practices altogether. You can no longer form a rabbi trust offshore or put a clause in a deferral plan that funds a rabbi trust if a company's fortunes start to decline. It's unclear if the Treasury will grandfather old rabbi trusts containing these verboten provisions or require them to be dissolved.

## Stock appreciation rights

Lawyers are waiting for the final word from the IRS, but it appears that the new law effectively kills "stock appreciation rights"--the election deadlines make it impossible for them to work. That's too bad, says Blair Jones, an executive compensation specialist with Sibson Consulting. Many corporations were in the process of adopting stock appreciation rights plans (employees share in stock gains, but don't take ownership of the stock) to replace stock option plans and sidestep the controversy over the proper accounting for stock options.

## Plan terminations

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Ashlea Ebeling, 12.27.04

If these new rules make you want to terminate your plan--and some small, privately held businesses might be tempted--hurry up. If you end the plan before Dec. 31, you'll owe taxes but no penalty. After that a termination could be an impermissible acceleration of distributions, subject to a 20% penalty. Certain plans, Zollars says, could be stuck in a catch 22 next year--unable to either terminate or operate in a way that doesn't incur penalties.

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