



Analysis of House and Senate Deferred Compensation Proposals

Both the Senate Finance Committee and the House Ways and Means Committee have approved significant modifications to the tax rules for nonqualified deferred compensation arrangements. The Senate Finance Committee proposal was most recently included in the pension bill (the “National Employee Savings and Trust Equity Guarantee Act”) approved by the Finance Committee in September (but still pending before the Committee because of the need to revisit the provision in the bill related to company-owned life insurance). The House Ways and Means Committee proposal is included in the FSC-ETI bill (H.R. 2896, the “American Jobs Creation Act of 2003”) approved by the Committee on October 28, 2003.

The two deferred compensation proposals are similar in their underlying structures, but, as discussed below, also have significant differences. It is possible that a version of the deferred compensation proposal will be enacted in the next few months. **Among the significant open issues is the effective date of the proposed legislation.**

Both nonqualified deferred compensation proposals would generally place restrictions on the timing of distributions and prohibit accelerations of distributions and the use of certain security devices (including financial health triggers and offshore trusts). The proposals generally would not limit the use of rabbi trusts.

- **Income Inclusion.** Under both proposals, a taxpayer would have to include in income all compensation deferred under a nonqualified deferred compensation plan (to the extent not subject to a substantial risk of forfeiture and not previously taxed) unless at all times during the year the plan satisfies specified requirements relating to timing of distributions and deferral elections. If previously deferred compensation becomes includible, there is also an interest charge relating back to the time the compensation was originally deferred and, in the Senate Finance proposal, a ten-percent additional tax.

- **Distributions.** Under both proposals, the nonqualified deferred compensation plan must provide that distributions may not be made earlier than:

- separation from service (6 months after separation from service for key employees of public companies);
- disability;
- death;
- a specified time (or pursuant to a fixed schedule) specified under the plan as of the date of the deferral;
- a change in ownership or control of the corporation or a substantial portion of its assets (but only as permitted by the IRS). Under the Finance Committee proposal, distributions following a change in control could not be made before one year after the change in



control in the case of individuals subject to section 16(a) of the Securities Act of 1934 (officers, directors, or 10-percent owners of publicly-held corporations). In addition, distributions to these individuals upon a change in control would be treated as excess parachute payments under section 280G of the Internal Revenue Code (even if the payments would not otherwise be treated as excess parachute payments). As a result of this treatment, there would be a 20-percent excise tax on the employee (in addition to normal income tax) and no deduction for the employer; or

- an unforeseeable emergency (narrowly defined to include severe financial hardship from an unexpected illness or accident, casualty loss, or other unforeseeable circumstances) of the participant, the participant's spouse, or a dependent, but only to the extent necessary to satisfy the emergency (and pay taxes on the amount distributed).

Further, the plan may not permit any acceleration of the specified time (or fixed schedule) for paying benefits. The Ways and Means Committee bill would allow the IRS to issue regulations providing exceptions from this "no acceleration" rule.

- **Investment Options.** The most significant difference between the two proposals is that under the Finance Committee version, investment options (including phantom or theoretical investment options) that a participant may elect under a nonqualified deferred compensation plan must be comparable to those which may be elected by participants of the qualified employer plan that has the fewest investment options. Under the Finance Committee version, investment options of a nonqualified deferred compensation plan could be less favorable or more limited than those of a qualified employer plan. The Finance Committee version would prohibit open brokerage windows, hedge funds, and investments in which the employer guarantees a rate of return above what is commercially available. The Treasury would be directed to issue guidance for situations in which there is no qualified employer plan that allows participants to direct investments.

- **Deferral Elections.** Both proposals generally provide that compensation earned during the year may be deferred only if the election to defer is made during the preceding taxable year (or at such other time as may be provided in regulations). (The Ways and Means proposal ties to compensation "for services performed during the year" rather than "compensation earned.") In the first year in which an employee becomes eligible to participate, the election can be made within 30 days of eligibility, but only as to services performed subsequent to the election. The plan may permit a subsequent election to delay a distributable payment or change the form of payment, but only if the subsequent election is made at least 12 months before the first scheduled payment and only if the plan requires that payments be delayed at least five years. The Ways and Means version would also require that elections to delay or change the form of a distribution not take effect for 12 months from the election date. The Finance version would permit more than one subsequent election with respect to an amount deferred.

- **Special Rules.**

- **Offshore Property in Trust.** Amounts set aside in an offshore trust (or other arrangement specified by the IRS) for the purpose of paying deferred compensation would be taxable when set aside if the assets are outside the United States (or when the assets are subsequently transferred outside the United States). In the Finance Committee version, this rule would not apply to assets located in a foreign jurisdiction when substantially all of the services to which the deferred compensation relates are performed in the foreign jurisdiction.
- **Change in Employer's Financial Health.** Deferred amounts would be taxable at the time a plan first provides that assets are restricted to the payment of benefits in connection with a change in the employer's financial health (or, if earlier, when the assets become so restricted).
- **Subsequent Earnings, Additional Tax, and Retrospective Interest.** An interest factor (and, in the Finance Committee version, a ten-percent additional tax) would apply to amounts taxed by reason of being offshore or secured against a change in financial health of the employer. Earnings on previously taxed offshore amounts and assets secured against a change in the employer's financial health would be immediately taxable.

- **No Inference.** The proposal would create no inference preventing the inclusion of deferrals in income pursuant to provisions of existing law.

- **Broad Regulatory Authority.** The Senate Finance proposal would repeal the 1978 moratorium on deferred compensation guidance and thus permit the Treasury to issue broad rules relating to nonqualified deferred compensation arrangements. Both versions also would give the Treasury Department broad regulatory authority to interpret the new deferred compensation provisions.

- **W-2 Forms.** The proposal would require W-2 reporting of compensation deferrals.

- **Effective Date.** The proposals would generally apply to amounts deferred in taxable years beginning after December 31, 2003. However, the Ways and Means version would provide limited transition relief: (i) irrevocable deferral elections made before October 24, 2003 (for 2004 compensation) would be subject to prior law and (ii) a brief period after enactment would be provided for participants to cancel existing deferral elections or terminate deferred compensation plan participation with respect to plans adopted before December 31, 2003.

AALU and its counsel have brought to the attention of Committee staff the fact that these proposed effective dates do not provide adequate time to amend existing plans with respect to 2004 deferrals. AALU will continue to seek an expansion of the transition relief including a full grandfather of 2003 deferral elections for 2004 compensation.



- **Additional Senate Finance Provision on Stock Option and Restricted Stock Gains.** The Senate Finance Committee legislation would provide that gains attributable to stock options (including exercises of stock options), vesting of restricted stock, and other employer security-based compensation could not be deferred by electing to receive a future payment in lieu of such amounts. This proposal would apply even if the future right to payment is treated as an unfunded promise to pay. The proposal is not intended to imply that any covered practices would result in permissive deferral of income under present law. The proposal would be effective after December 31, 2003.