



AMERICAN BENEFITS COUNCIL

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DEFERRED COMPENSATION PROPOSALS WOULD NEEDLESSLY CURTAIL BENEFICIAL PLANS

- Nonqualified deferred compensation plans provide a valuable source of retirement income to thousands of employees. Proposals included in corporate and international tax reform legislation passed by the Senate (S. 1637, the “Jumpstart Our Business Strength Act of 2004”) and pending in the House (H.R. 4520, the “American Jobs Creation Act of 2004”) would needlessly curtail many beneficial and non-abusive deferred compensation plans and dramatically limit the availability and attractiveness of such plans to middle managers and non-management staff who rely on them to supplement their retirement income.
- Moreover, the definition of “nonqualified deferred compensation plan” is so broad that the proposed requirements would apply to arrangements that do not involve voluntary participant deferral elections and many other practices that traditionally have not been considered deferred compensation arrangements.

Background

- Many employees depend on nonqualified deferred compensation plans to help supplement their retirement benefits. Nonqualified plans are necessary because of the many limits placed on 401(k) and other types of qualified retirement plans. These programs benefit many middle managers and non-management staff -- not just senior managers -- and are essential to attracting and retaining strong management and providing a valuable source of retirement savings.
- Unlike qualified retirement plans, no special tax rules are provided to employers that provide nonqualified plans. Earnings are taxable directly to employers on a current basis, and employers may not deduct amounts set aside until benefits are paid to employees. Employees bear the risk that the employer will become insolvent and unable to pay benefits, and pay tax on all amounts when benefits are received.

Proposed Legislation

- The proposals contained in the House and Senate versions of corporate and international tax reform legislation would extend significantly beyond potentially abusive practices. The proposals would immediately tax amounts deferred under “nonqualified deferred compensation plans” unless certain requirements are satisfied.
- The term “nonqualified deferred compensation plan” is defined so broadly that the proposed requirements would apply to arrangements that do not involve voluntary participant deferral elections, including defined benefit supplemental pension arrangements, and sweep in many practices (e.g., annual bonuses; stock options; restricted stock; restricted stock units; short-term deferrals; severance arrangements) that traditionally have not been subject to the federal tax rules that apply to deferred compensation.
 - Because many of the arrangements that would be swept in and treated as “nonqualified deferred compensation plans” typically would not meet the proposed requirements -- particularly the proposed distribution requirements -- amounts treated as “deferrals” under these arrangements could be subject to tax when vested (e.g., the spread on a stock option could be subject to tax immediately upon becoming vested and exercisable).
 - Applying the proposed requirements so broadly would severely limit employer flexibility in designing compensation arrangements that best meet their business needs and undermine long-term productivity and competitiveness.
 - The following arrangements should be excluded from the definition of “nonqualified deferred compensation plans”: (a) defined benefit supplemental pension plans; (b) stock options; (c) stock appreciation rights; (d) restricted property; (e) restricted stock units; (e) severance pay; and (f) short-term deferrals.
- Initial deferral elections generally would be required to be made before the beginning of the taxable year in which the services are performed giving rise to the compensation. This would have an unduly restrictive effect on deferrals of annual bonuses payable some time after the end of the taxable year (including bonuses payable under fiscal year plans), and payments under multi-year long-term incentive plans.

- Requiring that deferral elections be made prior to the period in which services are performed would mean that deferral elections with respect to these types of payments would have to be made several years before the compensation was payable and, in many cases, before the board of directors even establishes performance goals or bonus criteria.
 - Deferring long-term incentive payments and bonuses provides value to the corporation. Deferring compensation that otherwise would be paid currently helps align the interests of managers and shareholders. The deferral strengthens the managers' ties to the company and its performance.
 - Elections with respect to bonus and long-term incentive arrangements should be permitted so long as they are made at least 6 months prior to the date such amounts would otherwise be payable.
- The proposals would be effective for amounts deferred almost immediately after enactment. The Senate proposals would be effective for amounts deferred after 12/31/04. The House bill would be effective for amounts deferred after 6/3/04, but the amendments would not apply to amounts deferred after 6/3/04, and before 1/1/05, pursuant to an irrevocable election or binding arrangement made before 6/4/04.
 - To avoid retroactive application of the new requirements, the general effective date should be moved to no earlier than amounts deferred after 12/31/04.
 - Even if the general effective date is changed to amounts deferred after 12/31/04, the proposals could still be retroactive with respect to the application of the requirement that deferral elections be made the year before the year in which services are performed. In the case of an annual bonus to be paid in 2005 with respect to services performed in 2004, the deferral election would have had to have been made by 12/31/03. Similar retroactive application would also apply to long-term incentive plans spanning multiple years. To address this, the effective date for deferral election requirements should be delayed to no earlier than elections made after 12/31/04, with generous transition rules.
 - The transition rule in the House bill should apply to irrevocable elections made before December 31, 2004, and, with respect to

bonuses, fiscal year plans, and multi-year incentive plans, the transition rule should apply to “amounts deferred” in 2005, 2006, and 2007, to take into account the fact that payments under such plans typically would not have been payable until after 2005.

- Under the Senate legislation, amounts deferred under nonqualified plans that permit employees to elect how earnings are credited to a bookkeeping account would be immediately taxable unless the options offered are comparable to the investment options available under the employer's 401(k) plan.
 - The proposal would impose cumbersome and inflexible new requirements on investment elections, even though such elections do not control actual investments, any assets set aside by the employer remain subject to the claims of the employer's creditors, and most nonqualified plans offer far fewer options than are offered under the employer's 401(k) plan. The proposal ignores the fact that fiduciary rules are applicable to 401(k) plans but not to nonqualified deferred compensation plans.
- Under the Senate legislation, gains attributable to stock options, vesting of restricted stock, employer securities, or any other property based on employer securities transferred to the taxpayer, could not be deferred by electing to instead receive deferred amounts. Taxpayers would be taxed immediately on the present value of the right to receive future payments obtained in “exchange” for the stock options, employer securities, or other property based on employer securities transferred to the taxpayer. This proposal fails to recognize that—
 - Employees who make these elections give up the future right to receive the stock itself for the employer's unfunded promise to pay deferred amounts at a specified future time. This decision has significant economic non-tax consequences, most notably the risk that the employee will never receive the deferred amounts (e.g., because of the employer's insolvency).
 - Well-established tax principles allow employees and employers to restructure the form of compensation or time of payment a reasonable time before any amounts are actually payable.
 - These programs do not involve any “mismatch” or other tax abuse. Whether or not the election to exchange is made, the employee will be taxed – and the company will get a tax deduction – in the same year, i.e., when the amounts are actually paid.

- These programs offer employees some ability to tailor their future compensation to better meet their expected needs.