

AMERICAN BENEFITS COUNCIL
OVERVIEW OF MAJOR LEGISLATIVE PROPOSALS IN THE 108TH CONGRESS AFFECTING
NONQUALIFIED DEFERRED COMPENSATION

ITEM	CURRENT LAW	H.R. 2 (SENATE VERSION)*	H.R. 2896 (AMERICAN JOBS CREATION ACT OF 2003)**	NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT (“NESTEG”) AND (“JOBS”) S. 1637***
Definition of Nonqualified Deferred Compensation	Current law provides no single definition. Treas. Reg. §1.404(b)-1T defines deferred compensation as any payment made more than 2-1/2 months after the tax year in which the relevant services were rendered. Regulations under §31.3121(v)(2)-1(b) impose a special timing rule for employment taxes on deferred compensation plans that meet certain regulatory requirements (excluding welfare, stock plans, death benefits, and disability).	The legislative language covers any “plan,” “agreement,” or “arrangement” other than tax-qualified plans and plans of tax-exempt employers (<i>i.e.</i> , section 457 arrangements would not be covered). The legislation is not limited to elective arrangements and would apply to defined benefit supplemental pension arrangements. Query whether grandfathered split-dollar insurance arrangements could be viewed as deferred.	The provisions would apply to any “plan,” “agreement,” or “arrangement” that provides for deferral of compensation, other than tax-qualified plans, annuities and IRAs. All section 457(f) nonqualified arrangements for tax-exempt and governmental employers would be subject to these rules. Only qualified section 457(b) arrangements of governmental employers are exempted. Thus, section 457(b) arrangements for tax-exempt employers would be subject to these rules.	Same as to H.R. 2896.

* These provisions were passed by the Senate but were not included in the conference agreement on H.R. 2, The Jobs and Growth Tax Relief Reconciliation Act of 2003, which subsequently was enacted and signed by the President.

** Many of the provisions of H.R. 2896, introduced by Rep. Thomas, Chairman of the House Ways and Means Committee, and reported out of the Committee on October 28, 2003, are substantively similar to Senate Finance Chairman Grassley’s initial mark considered in connection with H.R. 2. Chairman Grassley’s initial mark was modified during consideration by the Senate Finance Committee, as reflected in the description of H.R. 2.

*** Statutory language for the NESTEG proposals are included in S. 1637, the “Jumpstart Our Business Strength (JOBS) Act,” which would amend the Internal Revenue Code to address issues related to international taxation and the World Trade Organization’s rulings on the FSC/ETI benefits.

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Timing of Deferrals	Case law interpreting the doctrine of “constructive receipt” supports an election to defer compensation that occurs any time prior to the date that amounts are due and payable. The IRS ruling position generally requires that deferral elections be made prior to the period in which the underlying services are performed.	No provision.	Generally follows the IRS ruling position. Deferral elections would be required prior to the year in which the services are performed or as provided in regulations. A special 30-day grace period is provided for new participants in a deferred compensation plan. [These provisions would require significant changes in practice particularly with respect to annual bonuses that typically are scheduled to be paid in the following February or March and for which deferral elections often are not filed until the third or fourth quarter in the year that the service is performed.]	Same as H.R. 2896.
Creditor Access and Domestic Rabbi Trusts	No current taxation if an employee is a general creditor with respect to an unfunded promise to pay compensation in the future. Compensation is “unfunded” even if amounts are irrevocably transferred to a rabbi trust as long as creditors may access the funds upon an insolvency event.	If funds are “set aside” directly or indirectly, the employee is taxed currently unless the funds are available “at all times” to pay general creditors and not merely after insolvency. [These provisions eliminate current-law rabbi trusts, which typically are irrevocable or become irrevocable on an event such as a change in	No apparent change in law related to domestic rabbi trusts. Employees would be subject to current taxation on benefits, however, to the extent assets could be removed from creditors upon a “change in the employer’s financial health.” [Query whether a change in law is required to achieve this result given Treasury’s authority under section 83. See	Same as H.R. 2896, with the addition of a 10-percent penalty for assets that may be removed from creditor access upon “a change in the employer’s financial health.”

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Creditor Access and Domestic Rabbi Trusts (continued)		control. Query what arrangements set aside assets “indirectly.”]	discussion on foreign trusts below.]	
“Foreign” Arrangements or Rabbi Trusts	No special rules apply. Foreign trusts and arrangements are subject to the same standards as domestic arrangements and rabbi trusts. Foreign rabbi trusts are specifically exempted from Treasury regulations governing U.S. persons who are beneficiaries of foreign trusts. See Treas. Reg. §1.672(f)-1.	The legislative language includes two different provisions on “foreign” trusts and arrangements. The provisions preclude foreign rabbi trusts by making benefits covered by such trusts and arrangements currently taxable, subject to Treasury’s authority to write exceptions. In addition, the legislation provides for current taxation of benefits where there is any factor that would make it “more difficult to reach the assets” than if the assets were held directly by the employer in the United States. These rules could be interpreted broadly to impact deferred compensation sponsored by foreign employers.		Similar to H.R. 2896, but with the specific statement that restrictions do not apply to the extent that employees are performing substantially all services in the foreign jurisdiction where the foreign trust is sited. [Note that this exception likely is not broad enough for multi-national businesses that maintain deferred compensation arrangements for groups of employees working in multiple countries.]
Limitations on Investment Selection	Participants may select from different investment return options to determine the	Investment elections would be limited to those that are “the same” as the employer’s qualified plan.	No provision.	Similar to H.R. 2, except that investment options must be “comparable” to the qualified plan of

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Limitations on Investment Selection (continued)	earnings or losses that accrue under the deferred compensation arrangement as along as any assets invested to hedge against the deferred compensation obligation remain assets of the employer. Treasury and IRS explicitly have approved deferred compensation arrangements for tax-exempt entities that provide such investment choice. See e.g., Prop. Reg. §1.457-7(c)(1).	[Query whether this rule is determined on a controlled group basis; query the result when the employer does not maintain a participant-directed qualified plan; query the result when the employer desires to provide fewer investment options than the qualified plan; query whether “the same” literally means the same vendor or fund or whether “the same” means a vendor or fund of the same type; query whether “the same” options includes investment options offered under a qualified plan maintained pursuant to a collective bargaining agreement. This provision raises numerous practical and administrative questions.]		the employer with the fewest options and, if there is no such plan, as provided by the Treasury in regulations. [Note that the prohibitions against investments in “hedge funds,” “brokerage windows,” and fixed rates of return that are “above what is commercially available,” which appeared previously in Joint Committee report language for NESTEG, do not appear in the statutory language of S. 1637.]
Payout Terms Including “Second Elections” and Other Changes	No current taxation until receipt of payments to the extent that the employee’s right to payment may be accelerated upon certain events not in the employee’s control or subject to substantial	Even if no rabbi trust were maintained, employees would be taxed currently unless payouts of deferred compensation were made only after a fixed period, such as the attainment of a specified age or a fixed period of deferral (e.g.,	The provisions would require payouts on a fixed schedule or upon the attainment of a specified age. Acceleration of payments would be barred except on “separation from service,” death, disability (as defined in the Social Security Act) and, in	Similar to H.R. 2896, except that the definition of disability is no longer keyed to Social Security and, instead, requires that the participant either be unable to engage in “substantial gainful employment” for at least 12 months due to a disability or be

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Payout Terms Including “Second Elections” and Other Changes (continued)	<p>limitations, such as a financial hardship, a termination of employment, a change in control, or disability (as defined by the deferred compensation plan). Changes in the deferral period or changes in the form of payment (e.g., from lump sum to installment) may be made prior to the time that payments are due and payable. [Many employers rely on favorable case law to allow changes in deferral and payout elections while an employee is still employed and in the tax year prior to the year that payments are scheduled to be made. As discussed above, the IRS ruling position historically has been more restrictive.]</p>	<p>after 10 years). Payments cannot be accelerated for “events” other than separation from service, death, or disability (as defined under the Social Security Act). [Note that the Social Security definition of disability may raise administrative issues and that most arrangements are keyed to the employer’s insurance policy. Common plan provisions providing for accelerated payouts upon termination of the plan, or in the discretion of the plan committee, or upon a determination that plan benefits are currently taxable would appear to violate the rule against accelerations. Note that the legislative language precludes only payout triggers that result in an acceleration of payments. The better technical reading is that the statutory language does not preclude changes in elections that lengthen the deferral period (e.g., deferring the payout date or</p>	<p><u>contrast</u> to H.R. 2, upon a change in control and unforeseeable financial emergency. [Query whether “separation from service” is intended to be a broader concept than termination of employment.] In addition to the rule against accelerations, the provisions would allow only one “second election” to delay a payout or change the form of the payout provided that the “second election” is made at least 12 months prior to the scheduled payout date and provides for an additional deferral of at least five years. There is no requirement that the second election be made prior to a termination of employment. [It appears that the second election rule would adversely affect the typical situation in which a participant changes from a lump sum to installment payments prior to retirement. Presumably, a change to installments would satisfy the rule only if the election delayed the commencement of any installment payment for 5 years.] In addition, any</p>	<p>receiving at least 12 months of “income replacement benefits” from an employer’s “accident or health plan.” [Note that disability typically is not paid from an “accident or health plan” within the meaning of the Internal Revenue Code.] Also, the top officers, as defined under Rule 16 of the Securities and Exchange Act would be required to wait 1 year for distributions to the extent that the distribution is caused by a change in control.</p>

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Payout Terms Including “Second Elections” and Other Changes (continued)		switching from a lump sum to installment payout). Nonetheless, there are concerns that the provisions are intended to preclude <u>any change</u> in the payment terms after the deferral has been made.]	“key employee” of a publicly-held company would be required to wait 6 months for the commencement of any payment triggered by a separation from service. For these purposes, a key employee is defined under Code section 416(i) as a top-50 officer with compensation in excess of \$130,000, a 5-percent owner, or a 1-percent owner with compensation in excess of \$150,000. Note that this definition likely encompasses a broader group of officers than the definition of a Rule 16 insider for purposes of the Securities and Exchange Act.	

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“Haircuts,” Penalty Withdrawals and Change in Control Payments	Regulations under section 451 are relied upon to avoid constructive receipt if elective withdrawal rights are subject to a penalty or “haircut” that is a substantial limitation on the employee’s ability to withdraw funds. The IRS allows plans to include a withdrawal right upon an unforeseen financial emergency without triggering constructive receipt and current taxation for all participants.	No acceleration of payments would be allowed, thereby eliminating “haircut” withdrawal rights and unforeseeable financial emergency payments. Payments upon a corporate change in control also would be precluded.	Same provisions as H.R. 2, except that change in control payments and payments upon an unforeseeable financial emergency <u>would be permitted</u> as discussed above. [Note that “change in control” is to be defined by regulations, which suggests that this exception may not be available until such regulations are published.]	Similar to H.R. 2896, but payouts to insiders within the meaning of Rule 16 of the Securities and Exchange Act would be prohibited for one year following the change in control and such payments would be treated as “excess parachute payments” under Code section 280G and subject to the 20 percent excise tax under Code section 4999.
Timing and Amount of Tax Imposed	Taxpayers on the cash method of accounting pay income tax in the tax year in which amounts are actually or constructively received.	If a plan violates the “funding” or payout rules discussed above, the employee would be immediately taxed on the amount deferred. If there is a change in a plan that violates the payout rules above, then the affected employee also would be subject to interest at the underpayment rate as if the deferred compensation had been included in the employee’s income on the earliest date that the employee was vested in the	Same as H.R. 2, except that interest is imposed at the underpayment rate plus one percentage point and the interest on underpayments also would apply to amounts covered by foreign trusts or arrangements.	Similar to H.R. 2896, but deferrals that violated the statutory rules would be subject to an additional penalty of 10 percent.

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Timing and Amount of Tax Imposed (continued)		benefit. [It appears that a violation of the payout rules could result in current taxation and interest payments only for affected employees and not taint all employees under the plan. As drafted, it appears that the interest on underpayments technically might not apply to arrangements that violate the creditor access rules.]		
Exchanges of Options and Other Exchanges of Equity Awards	The receipt of a nonqualified employee stock option typically is not a taxable event under Code section 83. Taxation occurs upon the exercise of the option and receipt of shares (or, if later, when the shares are no longer subject to a substantial risk of forfeiture). Some options include a provision allowing an employee to elect in advance that upon the exercise of the option the employee will forego the transfer of stock and instead accrue additional	The provisions would impose current taxation on the present value of any right to receive deferred compensation benefits if a taxpayer “exchanges” an option or “any other compensation based on employer securities” for a right to receive future payments. [There are numerous technical questions as to the scope and application of these rules since options typically are not “exchanged” for deferred compensation. There are also questions as to whether the “exchange” rule might be triggered if a deferred compensation plan	No provision.	Similar to H.R. 2.

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Exchanges of Options and Other Exchanges of Equity Awards (continued)	deferred compensation benefits. Under the case law, there is no constructive receipt or assignment of income because the election to defer is made in advance and prior to the time that the employee has a right to receive any transfer of property.	includes phantom stock or stock units and an employee elects to change investment elections (if permitted under other provisions of the legislation).]		
Persons Affected	Current law applies to all employees and independent contractors on the cash method of accounting. Special limitations apply to deferred compensation arrangements sponsored by governments and tax-exempt organizations under Code section 457.	The limitations on stock option exchanges would apply to all taxpayers. All other rules on deferred compensation are limited to employee-officers within the meaning of section 16 of the Securities Exchange Act of 1934 (<i>i.e.</i> , those officers subject to the short-swing profits rules of Rule 16(b)) and to any officer who would be treated as a Rule 16 officer if the employer corporation was subject to the Act). [As drafted, the provisions would apply only to entities in the corporate form and only to employees and not non-employee directors. It is not clear how broad	The provisions would apply to all employees, except that special distribution rules would apply to “key employees” of publicly-held companies within the meaning of Code section 416(i) as discussed above. Note that there is no specific carve-out for non-employees (<i>i.e.</i> , outside directors and consultants) but the statutory language suggests that the provisions are limited to employment relationships.	Similar to H.R. 2896.

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Persons Affected (continued)		an interpretation should be given to the rules for determining Rule 16 officers when the employer is not an issuer under the Securities and Exchange Act. Query whether officers of subsidiaries of a public company would be covered by this rule if they were not Rule 16 officers for the controlled group.]		
Effective Date	N/A	The above provisions related to stock options would apply to “exchanges” after 12/31/2003. The other deferred compensation provisions would apply to “amounts deferred” in taxable years beginning after 12/31/2003. The statutory language indicates that “deferral” includes earnings, which suggests that amounts deferred prior to 12/31/2003, and all earnings on those amounts after 12/31/2003 would be grandfathered. See discussion below on grandfather issues.	Clarifies that deferrals and earnings thereon made prior to 1/1/2004 are grandfathered under this legislation. Deferrals for 2004 payments also are grandfathered to the extent that they were deferred under a binding election made before October 24, 2003. Treasury is directed to provide guidance allowing individuals to cancel outstanding deferral elections for amounts earned during 2004 if such amounts would be subject to current taxation under the legislation as enacted. [Note that the October 24, 2003 date is problematic for	Applies to amounts deferred in 2005 and thereafter and earnings thereon and to stock option exchanges in 2005 and thereafter. Treasury is directed to provide guidance allowing individuals to cancel or amend arrangements entered into prior to 1/1/2005 with respect to compensation earned in 2005 and thereafter.

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Effective Date (continued)		[Query whether a deferral occurs at the time that an election is filed or at the time that compensation otherwise would be paid.]	companies that have given executives until the end of October (or later) to file deferral elections for bonuses payable in 2004.]	
Potential Grandfather Rules	N/A	Assuming that pre-2004 deferrals and earnings would not be subject to the new rules, there is no apparent limitation on grandfathered deferrals and earnings. [Presumably, plans in existence on 12/31/03 could continue to operate with respect to previously deferred amounts and the payout provisions under current law (e.g., “haircut” withdrawal rights) and rabbi trust rules under current law would continue to apply. Query whether there are any limitations on deferral elections filed prior to 1/1/2004 for compensation payable in 2004 and thereafter.]	Same as H.R. 2.	Same as H.R. 2 and H.R. 2896.
Regulatory Authority	In 1978, the IRS and Treasury issued a proposed regulation, 1.61-16, which would tax currently any amount that an employee voluntarily deferred	As drafted, the legislation contains no special regulatory mandate. Treasury would have authority to write regulations implementing a new statutory provision even if	No repeal of section 132 of the Revenue Act of 1978, but allowing Treasury to write rules governing the timing of deferral elections (see discussion above) would eliminate	NESTEG repeals section 132 of the Revenue Act of 1978, and Treasury is instructed not to implement Prop. Reg. 1.61-16. These provisions are not included in S. 1637.

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Regulatory Authority (continued)	from salary or bonuses (other than qualified plans). Under the proposed regulation, the assignment of income doctrine would apply at the time that the employee made the election to defer. Treasury has stated that it would not finalize the regulation if given authority to write regulations in the future. In section 132 of the Revenue Act of 1978, Congress directed Treasury and IRS to tax deferred compensation arrangements under the principles in place on February 1, 1978 (just prior to the issuance of the proposed regulation). Section 132 has not precluded the IRS from continuing to develop its own ruling positions (e.g., Rev. Proc. 92-64 (setting forth a ruling position on rabbi trusts); Rev. Proc 92-65 (modifying the rulings position on the timing of deferral elections)).	section 132 of the Revenue Act of 1978 is not repealed.	one area perceived to be covered by the regulatory bar of section 132. Treasury also would have authority to prescribe regulations necessary to carry out the proposal, including specific authority to write rules (i) valuing the amount deferred under a non-elective, defined benefit-type arrangement; (ii) defining change in control; (iii) exempting arrangements from the offshore trust rules if they do not result in an “improper deferral”; and (iv) disregarding any substantial risk of forfeiture where necessary to carry out the purposes of the legislation. This latter item is rather curious since Treasury already has authority to regulate what is a substantial risk of forfeiture under Code sections 83 and 457 and query what this additional authority is intended to provide.	

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Annual Reporting	No tax reporting of deferred compensation prior to inclusion in employee’s income other than deferrals subject to early inclusion for employment taxes under Code section 3121(v). Note that the Department of Labor has authority to require reporting of such arrangements.	No provision.	Provisions would require annual reporting to the IRS of “amounts deferred” on the Form W-2 even if amounts are not currently includable in income.	Same as H.R. 2896.
Estimated Revenue Effect	N/A	Raises \$4.4 billion as estimated by the Joint Committee on Taxation.	Raises \$800 million as estimated by the Joint Committee on Taxation.	Raises \$879 million as estimated by the Joint Committee on Taxation.