



KEY ISSUES IN PENDING DEFERRED COMPENSATION LEGISLATION

The nonqualified deferred compensation amendments included in the corporate and international tax reform legislation passed by the House and Senate (sec. 671 of H.R. 4520, the "American Jobs Creation Act of 2004"; sec. 671 and 672 of S. 1637, the "Jumpstart Our Business Strength Act of 2004") would extend significantly beyond potentially abusive practices, needlessly curtail many beneficial compensation arrangements, and apply to middle managers and non-management staff -- not just to senior executives.

Effective Date/Transition and Grandfather Rules.

Issue: The proposals would be effective for amounts deferred almost immediately after enactment – with no transition period for employers to modify their compensation structures. Under the current House and Senate effective dates, the proposals on the timing of elections would even be retroactive with respect to bonus arrangements that have already begun. Moreover, language in the Ways and Means report suggests that amounts that were deferred before the effective date would lose any grandfather protection if an employee makes a subsequent election with respect to those amounts after the effective date (*e.g.*, an election prior to retirement between a lump sum and installments).

Proposals:

Provide for a prospective effective date with sufficient transition time to make appropriate plan changes (*e.g.*, amounts deferred after 1/1/06).

Clarify that the new rules will not apply to amounts originally deferred prior to the effective date or to amounts that have accrued under a nonelective plan prior to the effective date.

Provide transition relief for compensation earned prior to the effective date and for which a deferral is filed prior to the effective date. For example, if there is a 1-1-05 effective date, transition relief should be provided to allow a deferral election in 2004 for compensation earned in 2004 that otherwise would be payable in 2005, the timing of which would be governed by current law.

Specify that employers maintaining deferred compensation arrangements, and participants in such arrangements, have a least 12 months after enactment to unwind

the arrangements and/or elections thereunder, with current taxation (but no interest or penalties) on amounts deferred thereunder.

Timing of Elections.

Issue: Initial deferral and payment 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 unnecessarily restrict a host of common practices.

- Elections with respect to bonuses payable some time after the end of the taxable year (including under fiscal year plans) and payments under multi-year incentive plans could be required to be made several years before the compensation was payable and even before the board of directors establishes eligibility and performance criteria. (The Ways and Means report does direct Treasury to provide some relief for incentive bonuses earned over multiple years, but a statutory change is needed.)
- Payments under supplemental pension plans could no longer be made in the same form and at the same time that the employee elects under the employer's qualified pension plan at retirement.

Proposal:

- 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 election timing restrictions should not apply with respect to payments under "mirror" supplemental pension plans where such payments are dictated by the employee's election under the employer's qualified plan. "Mirror plans" are plans that provide a supplemental accrual on the basis of the same benefit formula and definition of compensation (other than the tax limits) as the underlying qualified pension plan.
- Alternatively, employees in all nonelective defined benefit arrangements (not just mirror plans) should be allowed to elect 12 months prior to payment as to the form of benefits and such election should not be subject to the rule requiring that re-deferrals be made for a period of at least 5 years. Such a rule would facilitate elections between different installment options and between installment options and lump sums.

Broad Definition of Deferred Comp.

Issue: The definition of "nonqualified deferred compensation plan" is so broad that the legislation would curtail the following arrangements: (1) those that do not involve voluntary participant deferral elections, such as supplemental pensions; (2) various

forms of equity-based compensation programs, including programs already regulated by Code sec. 83 (*e.g.*, stock options, restricted stock) and other programs (*e.g.*, restricted stock units, stock appreciation rights, and phantom stock); (3) arrangements for tax-exempts already regulated by section Code sec. 457; and (4) other compensation arrangements that traditionally have not been viewed as deferred compensation, such as severance arrangements. The breadth of the definition creates overly complicated tax law rules and will severely limit employer flexibility in designing performance-based compensation arrangements that best meet their business needs.

Proposal:

- Carve out of the definition of nonqualified deferred compensation (1) transfers of property subject to Code section 83; (2) other equity-based forms of compensation (*e.g.*, restricted stock units, stock appreciation rights, and phantom stock); (3) deferred compensation arrangements already governed by Code section 457; and (4) severance arrangements.

Restrictions on Investment Control.

Issue: 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. Report language in the Senate Finance "NESTEG" pension reform legislation would also prohibit the use of open brokerage windows, hedge funds or non-commercially available rates of return. These proposals would impose unnecessarily rigid 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 nonqualified plans typically offer far fewer options than 401(k) plans.

Proposal:

- Eliminate the provisions on comparable investments and other restrictions on investments in the conference agreement. If the proposal is not eliminated, it should be made clear that any restrictions apply only to nonqualified deferred compensation plans that provide investment choices, and plans that do not provide choice continue under current law.

Prohibition on Employer Stock Deferrals.

Issue: 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. The provision is overly broad. It imposes greater restrictions on employer stock-based compensation than compensation paid in cash and could result in punitive taxation of employees even when the employee has not been given any “election” to change the equity arrangement, including as a result of a corporate restructuring or similar transaction or an employer-initiated employee transfer.

Proposal:

- Eliminate the provision in the conference agreement.