



Additional Technical Issues and Questions in Deferred Compensation Legislation

Coordination with tax withholding for employment taxes (FICA) for Key Employees and Section 16 Officers.

Issue: Under the Regulations under Code section 3121(v), employment taxes under the Federal Insurance Contribution Act attributable to deferred compensation benefits often must be collected prior to the time of payment. The employee's portion of the FICA taxes reduces the employee's nonqualified deferred compensation benefit and, thus, is a deemed distribution to the employee even though the amounts are paid over to the government on the employee's behalf and not directly to the employee. To the extent that these deemed distributions occur in order to satisfy an obligation under Code section 3121(v), they should be treated as distributions pursuant to a fixed schedule and, therefore, satisfy the provisions of Code section 409A that generally require distributions only at pre-determined periods (with exceptions for death, disability, or termination of employment, etc.) Particular problems arise, however, where key employees are precluded from receiving any distribution within 6 months of a termination of employment or, under the Senate bill, where Section 16 insiders are penalized if a distribution is made within a year of a change in control. In those cases, the deemed distribution required to pay FICA taxes would occur prior to the 6-month or 1-year period.

Proposal: Clarify that penalties under Code section 409A do not apply solely because of a payment of taxes made to satisfy an obligation under Code section 3121(v).

Application of Penalties in the Case of Operational Failures

Issue: A violation of the statutory rules in a plan of nonqualified deferred compensation would result in taxation and penalties for all participants covered by the plan (e.g., where the plan documents allowed all participants to take early withdrawals that are precluded under the new rules). The statute should impose a different result, however, where a violation is limited to a particular group of participants because of an operational error with respect only to the particular group. For example, if an employer inadvertently allows one employee to make a late deferral election, all other employees who filed timely elections under the terms of the plan should not be taxed and penalized. If operational errors result in taxation to all participants, then employers will be forced to create separate one-person arrangements and documents for each individual.

Proposal: Clarify that operational errors cause taxation and penalties only for the affected participant(s).

Application to Compensation Arrangements Funded by a “Secular Trust” and 457(f) Arrangements.

Issue: In some circumstances, an employer may fund a compensation arrangement (e.g., through a so-called “secular” trust), which results in current taxation to employees prior to actual payment to the employees. Under Code sections 83 and 402(b), employees are taxed at the time that they have a vested interest in a funded trust or receive other property. The statutory provisions should not apply when an employee no longer is deferring the taxation of compensation but is deferring actual receipt.

Proposal: Clarify that “deferred” compensation under the terms of the statute applies only to compensation for which the taxation has been deferred and no longer is applicable once an employee has taken into income a transfer of property or economic interest related to that deferred compensation obligation. This same rule should apply under Code section 457(f) arrangements where employees are taxed when there is no longer a substantial risk of forfeiture.

Issues for Delayed Payments to Key Employees and Section 16 Insiders

Issue: Problems will arise for arrangements in which compensation vests and is paid on retirement because of the rule that precludes key employees from receiving any distribution within 6 months of a termination of employment or, under the Senate bill, where Section 16 insiders are penalized if a distribution is made within a year of a change in control. For example, if a compensation promise vests upon retirement, key employees cannot be paid until 6 months later and the commencement of supplemental pensions will not be allowed until 6 months after retirement. There are also significant questions as to how these rules apply to equity compensation. If stock options and other equity arrangements are not carved out of the definition of nonqualified deferred compensation as requested, must company officers wait six months after retirement to exercise options or be transferred restricted stock?

Proposal: Eliminate the restrictions on timing of payouts to key employees and Section 16 officers. Alternatively, make clear that a transfer of stock upon vesting at retirement need not be delayed for the 6 month/1 year period for key employees and Section 16 officers after a change in control.

Involuntary Distributions

Issue: The legislation's restrictions on in-service distributions do not allow employers to terminate a deferred compensation arrangement and pay out amounts to executives at the company's discretion. Employers need this flexibility to address changing business environments and other business circumstances.

Proposal: Eliminate the tax penalties where amounts are distributed prior to the scheduled date because the employer terminates the deferred compensation arrangements for all employees and pays out all amounts.