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Client Alert

Planning Should Begin Now To Prepare For Changes To Nonqualified Deferred Compensation Arrangements Under Legislative Proposals

Executive Compensation & Employee Benefits **July 30, 2004**

Both the Senate and the House have passed proposed legislation that would significantly impact the taxation of nonqualified deferred compensation arrangements under the Internal Revenue Code of 1986, as amended (the Code). The Senate passed S. 1637, the "Jumpstart Our Business Strength (JOBS) Act of 2004" on May 11, 2004 and the House approved H.R. 4520, the "American Jobs Creation Act of 2004" on June 17, 2004. The deferred compensation proposals in both bills are similar in most respects. There are a few significant differences, however, that must be reconciled in conference before any legislation is enacted. Consequently, some of the proposals discussed in this Alert may be changed or eliminated from the final version of the legislation. Also, Treasury regulations issued after the legislation is enacted could have a material effect on the impact of the new rules.

Conferees were appointed in early July and it is expected that a bill will be reported by the Conference Committee in the early Fall.

Nonqualified Deferred Compensation Plan Broadly Defined

The definition of nonqualified deferred compensation in the proposed legislation is sweeping and includes any plan or arrangement that provides for the deferral of compensation, whether voluntary or not. The types of deferral arrangements covered include:

- elective salary deferral arrangements;
- elective annual and long-term bonus deferral arrangements;
- SERPs;
- excess plans;
- phantom stock plans;
- restricted stock units;
- SARs;
- Section 457(b) plans of tax-exempt organizations;
- Section 457(f) "ineligible" plans of tax-exempt organizations and governmental units; and
- directors deferred compensation plans.

It is not clear how the new rules would apply to incentive stock options, nonqualified stock options or restricted stock, although the deferral of stock option gains and the exchange of other equity-based compensation for unfunded deferred compensation payable in the future is specifically prohibited by the Senate bill. Tax-qualified plans, tax-deferred annuities, SEPs, SIMPLE plans, and governmental 457(b) plans are excluded. Bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans are also excluded from the definition of nonqualified deferred compensation plan.

Requirements to Avoid Triggering Current Tax on Vested Amounts Deferred under a Nonqualified Deferred Compensation Plan

Both the House bill and the Senate bill would tighten the rules for nonqualified deferred compensation arrangements. All participants of nonqualified deferred compensation plans are subject to the rules and the violation of any condition with respect to one participant will affect all participants in the same plan. All amounts deferred under a nonqualified deferred compensation plan after the effective date will be currently taxable (except to the extent the amount is subject to a substantial risk of forfeiture) unless certain requirements are satisfied:

- ***Restrictions on Distributions.*** The plan must provide that compensation deferred may not be distributed earlier than:
  - Separation from service, subject to a 6-month delay for certain key employees of public companies;
  - Disability;
  - Death;
  - A specified time or fixed schedule under the plan, but not a time keyed to the occurrence of an event;
  - Upon a change of control, to the extent provided for in Treasury regulations. The Senate bill imposes a one-year delay for distributions upon a change of control to corporate officers and directors who are subject to the reporting obligations of Section 16 of the Securities Exchange Act of 1934. Also, under the Senate bill, a distribution to a Section 16 officer or director within one year from the change of control would be treated as an excess parachute payment under section 280G of the Code and subject to the 20% excise tax under section 4999; or
  - The occurrence of an unforeseeable emergency.

  Comment: Elections keyed to retirement will still be permitted, but elections keyed to a distribution under a qualified plan, or a provision providing for distribution of the amounts deferred if and when they are deemed taxable, will not.

- ***No acceleration of payments***. The plan cannot accelerate the time or schedule of any payment under the plan, except as otherwise provided for in Treasury regulations.

  Comment: "Haircuts" (where a participant's distribution is reduced by a specified percentage if he or she elects an accelerated distribution) will no longer be allowed.

- ***Initial Deferral Election.*** The initial deferral election, if applicable, must be made no later than the close of the taxable year preceding the taxable year in which the participant performs the services giving rise to the compensation to be deferred. In the first year of participation, the election may be made within 30 days after the date the participant becomes eligible under the plan. The time and form of distribution must be specified at the time of the initial deferral.

  Comment: Many plans currently have shorter election periods that will have to be changed. Furthermore, this is particularly onerous for bonus plans that determine and pay bonuses in the year following the year earned. For example, a bonus keyed to individual and/or company performance in 2004 will typically not be determined until early 2005. However, under both bills elections would have to have been made in 2003. Even when an employer's fiscal year is not the calendar year, initial deferral elections would still have to be made in accordance with the calendar year election rule. For example, for a bonus keyed to performance for the fiscal year ending September 30, 2005 and determined in November 2005, elections would have to have been made in 2003.

- ***Subsequent Deferral Election.*** If the plan permits a subsequent election to defer payment or change the form of payment, the election cannot take effect until at least 12 months after the date of the election. Except in the case of elections relating to distributions on death, disability or unforeseeable emergency, the first payment with respect to which the election is made must be deferred for at least 5 years from the date payment would otherwise have been made under the initial election. An election related to a distribution to be made at a specified time may not be made less than 12 months prior to the date of the first scheduled payment. The Senate bill only permits one subsequent election with respect to an amount deferred. There is no restriction on the number of subsequent elections in the House bill.

  Comment: Plans will have to be reviewed to determine which subsequent election features need to be changed.

- ***Investment Options.*** The Senate bill requires that the plan restrict any investment options to those available under the employer's tax-qualified defined contribution plan which has the fewest investment options. There is no similar requirement in the House bill.

  Comment: This requirement will affect SERPs, excess plans and other top-hat arrangements and will significantly limit the choices currently available. Where an employer has more than one qualified defined contribution plan, it will have to determine which plan offers the fewest investment options. This may not be the plan to which the SERP or excess plan relates.

Penalties

If a nonqualified deferred compensation plan violates any of the above requirements, all vested deferrals under the plan will be currently taxable and subject to a penalty, even if the violation only occurs with respect to a single participant. The House bill imposes interest at the underpayment rate plus 1% on underpayments that would have occurred had the amount been taxable when first deferred or, if later, when the amount is no longer subject to a substantial risk of forfeiture. The Senate bill imposes interest at the underpayment rate on underpayments that would have occurred had the amount been taxable when first deferred or, if later, when the amount is no longer subject to a substantial risk of forfeiture, and an additional 10% penalty tax applies to amounts required to be included in income.

The Senate bill also prohibits the deferral of stock option and restricted stock gains by providing that any exchange of an option, restricted stock or any other property based on employer stock for deferred payments will result in the present value of that right being included in gross income in the year of the exchange. It does not matter whether the transfer was initiated by the participant or the employer.

Offshore Trusts

Assets set aside in an offshore trust for the purpose of paying nonqualified deferred compensation will be treated as property transferred in connection with the performance of services under section 83 of the Code, even if the assets are subject to the general claims of creditors. The Senate bill provides an exception for assets located in a foreign jurisdiction if substantially all the services to which the nonqualified deferred compensation relates are performed in that foreign jurisdiction. Earnings on these assets will be treated as additional transfers of property.

A transfer of property under section 83 will also occur if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation (as opposed to being available to the claims of creditors).

In such cases, participants will be immediately taxed on deferred amounts that are no longer subject to a substantial risk of forfeiture and the penalties described above will apply.

Reporting Requirements on W-2

Employers will be required to report amounts deferred on Form W-2 for the year deferred, even if the amount is not currently includible in income for that year.

Current Effective Dates of the Bills Will Be Burdensome

Concerns have been raised about the current effective dates of each bill. The House bill would be applicable to amounts deferred after June 3, 2004, except for amounts deferred before January 1, 2005 under an irrevocable election or binding arrangement made before June 4, 2004. The Senate bill would be applicable to amounts deferred or exchanged after December 31, 2004. The House bill contains a transition rule requiring Treasury regulations to be issued providing a limited period during which participants in nonqualified deferred compensation plans adopted prior to June 4, 2004 may terminate participation or cancel an outstanding deferral election with regards to amounts earned after June 3, 2004 if such amounts are includible in income as earned. Similarly, the Senate Bill contains a transition rule requiring Treasury regulations to be issued providing a limited period during which participants in nonqualified deferred compensation plans adopted on or before December 31, 2004 may terminate participation or cancel an outstanding deferral election with regards to amounts earned after December 31, 2004 if such amounts are includible in income as earned. However, neither the House nor the Senate transition rules address compensation payable in 2005 which is earned in 2004 for which a deferral election needed to have been made by the end of 2003.

Planning Issues Raised by the Proposals

- Annual bonuses are often not determined and paid until 2-3 months after the end of the performance period, which is typically the calendar year. Many employers currently allow bonus deferral elections to be made during the performance year. However, under the new initial deferral election rules, the election would have to be made prior to the beginning of the performance year. This requirement raises a problem for 2004 annual bonuses unless a transition rule applies, because it is already too late to make an initial deferral election under the proposed timelines and effective dates. Employers with annual bonus plans have the following options available to them:
    - Monitor the legislative process and review the final legislation and Treasury regulations to determine if a transition period applies.
    - Establish a process for making current deferral elections for 2004 annual bonuses to increase the likelihood that the election may fall within whatever transition rule may ultimately apply.
    - Employers could also consider amending the plan (other than for Code Section 162(m) "covered employees") to have the current performance period end prior to the end of the year, allowing for the 2004 bonuses to be determined and paid before December 31, 2004. To the extent that the plan permits deferrals, the timing of the election to defer must be made sufficiently in advance of payment to avoid constructive receipt under current law.
- The proposed distribution rules are restrictive. Haircut provisions in salary deferral and bonus plans would no longer be permitted. SERPs and excess benefit plans could not tie commencement of payments to the commencement of payments under the related qualified plan because that is not necessarily a distributable event. SERPs and excess benefit plans, could, however, provide for distribution at a specified age or at separation from service (subject to a six-month delay in certain cases). As a plan termination is not a distributable event, employers will need to consider the impact of the rules on their ability to terminate plans if termination would trigger immediate distributions.
- The proposed rules would eliminate the tax timing flexibility of SARs in the absence of an interpretation by Congress or the Treasury Department that the rules do not apply to SARs, since the election rules would require participants to designate the exercise date at the time of their initial election. Employers should review all outstanding SARs and consider advising employees to exercise by December 31, 2004 and accelerate if necessary.

- Mirror plans, where the plans provide for spillover contributions once a limit is reached in the underlying qualified plan, will become more complicated and will need amendments to comply with the new legislation. For example, typically when a deferral rate in the qualified plan is changed, the same change occurs in the mirror plan. This will no longer be permissible since the timing rules will require the elections in the mirror plan to be made in the prior year. Similar issues will need to be addressed with respect to investment options in the mirror plan where they are tied to the underlying qualified plan which may not have the fewest investment options.

Additional Information

If you wish to obtain more information on the ramifications of the proposed nonqualified deferred compensation rules on your plans, please contact one of the members of the Pillsbury Winthrop executive compensation and benefits team. Questions regarding this alert may be directed to Susan P. Serota (212-858-1125 or *sserota@pillsburywinthrop.com)* or Peter J. Hunt (212-858-1139 or *phunt@pillsburywinthrop.com)* in New York, Glenn Borromeo in San Francisco (415-983-1733 or *gborromeo@pillsburywinthrop.com)*, Cindy V. Schlaefer in Silicon Valley (650-233-4023 or *cschlaefer@pillsburywinthrop.com*), and Jan H. Webster in Carmel Valley (858-509-4012 or *jwebster@pillsburywinthrop.com)*.