PRELIMINARY DRAFT DISCUSSION DOCUMENT

August 25, 2004

Deferred Compensation Legislation

1. Postpone the effective date: The deferred compensation provisions of S. 1637 apply to amounts deferred in taxable years beginning after December 31, 2004. By contrast, most of the deferred compensation provisions of H.R. 4520 apply to amounts deferred after June 3, 2004, except for amounts deferred after June 3, 2004, and before January 1, 2005, pursuant to an irrevocable election or binding arrangement made before June 4, 2004. Neither bill sets a practical effective date. Employers' resources are already stretched thin well into 2005 by the need to comply with Sarbanes-Oxley internal control requirements, new accounting standards for stock compensation, and other major new developments that require the attention of accounting, finance, and human resources staff. The Senate bill's January 1, 2005, effective date does not give employers, plan administrators, and employees sufficient time to analyze their plans and revise their plan documents, communications materials, election forms, and computer-based systems to reflect the new provisions, while the House bill's retroactive effective date is wholly unfair and impractical. The following three changes should be made:

a. The deferred compensation provisions should apply to amounts deferred after *the later of* (i) December 31, 2005, or (ii) the first month that begins at least three months after the date on which the Treasury issues comprehensive regulations or other guidance under the provisions; if this is not done, then at the very least, the conferees should prescribe a "reasonable, good faith" compliance standard until final regulations are issued;

b. The provisions should not apply to amounts otherwise payable after the effective date (including earnings credited to those amounts) if (i) the deferred compensation arrangement is entered into (*e.g.*, any deferral election is made) before the effective date and (ii) the majority of the services to which the deferred compensation relates are performed before the effective date; and

c. The legislation should allow a reasonable period of time after the effective date within which a participant may cancel a prior deferral election that would otherwise cause the participant to be subject to the new deferred compensation provisions. This cancellation opportunity will avoid subjecting a participant to current tax on amounts he or she deferred before the new tax rules governing those deferrals could be known.

See S. 1637, § 671(e); H.R. 4520, § 671(d).

2. Accommodate benefit restoration and other supplemental retirement plans: S. 1637 and H.R. 4520 impose the same set of rules for both stand-alone elective deferred compensation plans (which allow employees to defer part of their compensation without regard to their deferrals under any other plan) and benefit restoration and other supplemental plans (which are linked to the employer's qualified plan(s), typically provide benefits that designated Internal Revenue Code limits prevent a qualified plan from providing, and link (1) an employee's deferrals to the employee's elective deferrals under the employer's related qualified defined contribution plan and (2) an employee's benefit distributions to the employee's benefit distributions under the employer's related qualified defined benefit or defined contribution plan). Congress has previously defined, and recognized the importance of, such supplemental plans in legislation governing the application of state "source tax" rules to deferred compensation. *See* 4 U.S.C. § 114. These supplemental plans generally apply to all employees who are affected by the designated Internal Revenue Code limits: they are not limited to a few senior executives. Because supplemental plans are critical to the retirement planning of employees affected by the limits, the conference bill should incorporate the definition used in the "source tax" legislation and permit such plans to allow employees to receive distributions in the same form and at the same time as they receive distributions under the related tax-qualified plan. (In some cases, a supplemental plan offers additional distribution options—for example, the supplemental plan might allow employees to take a lump-sum distribution in recognition of the fact that the supplemental benefit is unfunded and unsecured, but the employer might not wish to offer a lump-sum option under its basic retirement plan. An employee's ability to elect these additional options would be governed by the general rules relating to distributions after severance from employment, which we discuss below in item 7.) Similarly, the conference bill should allow an employee to make deferrals under a defined contribution restoration plan that are based on the employee's deferrals under the employer's related tax-qualified defined contribution plan (which typically allows employees to change their deferral elections throughout the year and which would therefore, as the bills are currently drafted, cause the vast majority of defined contribution restoration plans to violate the bills' advance election requirements). *See* IRC § 409A under S. 1637; IRC § 409A under H.R. 4520.

3. Do not accelerate the taxation of deferrals that are made in accordance with the bill's requirements: Both S. 1637 and H.R. 4520 provide that if a nonqualified deferred compensation plan fails to meet *any* of the bill's requirements, either in form or in operation, then *all* compensation deferred under the plan by *all participants*, for the taxable year and *all preceding taxable years*, is includible in gross income. This means that even a minor glitch in the language or operation of the plan would cause punitive tax consequences to be imposed on all plan participants --- including those whose rights were not affected by the glitch. This draconian rule must be moderated; it must not be included in the conference bill. The bill should provide that only those deferrals that fail to comply with the bill's requirements will be subject to accelerated taxation. Alternatively, *at the very least*, the bill should provide that (a) in the case of an operational failure, the only deferrals that would be taxed on an accelerated basis are the deferrals actually affected by the operational failure and (b) in the case of a formal failure (a failure of the plan's language to comply with the bill's requirements), the only deferrals that would be taxed on an accelerated basis are the deferrals that were subject to the defective plan provision (for example, in the case of a plan provision that was defective only with respect to

bonuses payable in 2006, but not with respect to base salary and not with respect to other years, tax would be accelerated only with respect to bonus deferrals in 2006). In addition, the conferees should direct the Treasury to establish a voluntary correction program (similar to the programs in effect for qualified and § 403(b) plans) for nonqualified deferred compensation plans with operational or formal defects. *See* IRC § 409A(a)(1)(A) under S. 1637; IRC § 409A(a)(1)(A) under H.R. 4520.

4. <u>Clarify that the bill does not apply to prior deferrals</u>: Although the Senate and House bills' effective date provisions differ from one another in some respects, each bill fails to make clear what rules apply after the bill's effective date to amounts that were originally deferred before the effective date. For example, neither bill makes clear whether prior deferrals will continue to be governed, after the bill's effective date, by the prior law regarding accelerated distributions and re-deferrals. The conferees should clarify that, after the bill's effective date, amounts deferred in the past (including earnings on past deferrals) will continue to be governed by prior law as long as the terms of the plan are not amended after the date of enactment to give participants greater control over the timing of plan distributions. Because amounts deferred in the past, and earnings credited to those deferrals, were deferred in reliance on prior law and in reliance on the prior terms of the plan, Congress should not change the rules governing those deferrals after the deferrals were made. Thus, for example, the bill should apply only to *initial* deferrals after the effective date and *not* to amounts initially deferred before the effective date even if the form or timing of payment of those previously deferred amounts is changed after the effective date. Similarly, the conference report should *not* include the statement in the House Ways and Means Committee report (H.R. Rep. No. 108-548 (Pt. 1) at p. 348) that "amounts further deferred under a subsequent election with respect to amounts originally deferred before June 4, 2004, are subject to the requirements of the provision." *See* S. 1637, § 671(e); H.R. § 4520, § 671(d).

5. <u>Incorporate the established definition of "nonqualified deferred compensation"</u>: Both S. 1637 and H.R. 4520 define "nonqualified deferred compensation plan" to mean "any plan that provides for the deferral of compensation," subject to a limited number of exceptions. This circular definition leaves open a myriad of questions that could take years to resolve. Among the unanswered questions are whether severance pay, retirement incentives, stock options, and stock appreciation rights ("SARs") are nonqualified deferred compensation. One way to address this issue is to adopt the existing definition of nonqualified deferred compensation in Treas. Reg. § 31.3121(v)(2)-1(b), in which the Treasury has already worked out answers to these questions. *See* IRC § 409A(d)(1) under S. 1637; IRC § 409A(d)(1) under H.R. 4520.

6. <u>Do not adopt the Senate bill's investment option rule</u>: S. 1637 (but not H.R. 4520) provides that deferred compensation plans that allow participants to elect how investment experience will be credited to their deferred compensation accounts (*i.e.*, plans that allow participants to elect to have their accounts allocated to hypothetical investment options) will not be effective for income tax purposes unless the plan's hypothetical investment options are comparable to the actual investment options under the employer's qualified defined contribution plan with the fewest investment options. *This rule should not be included in the*

conference bill. The provision is unnecessary and unworkable. It is unnecessary because such elections do not give participants security or control over any real investments, and they do not give participants greater access to, or control over the timing of, deferred compensation payments. It is unworkable because major employers and their affiliates typically sponsor numerous qualified defined contribution plans, and it will be extremely difficult, if not impossible, to identify the defined contribution plan with the fewest investment options at all times, since this will change frequently due to such events as mergers, acquisitions, and plan changes. The provision also fails to take into account the fact that many qualified defined contribution plans offer *no* investment options (for example, ESOPs (for those participants who do not have investment diversification rights under IRC § 401(a)(28)) and conventional profit-sharing and money purchase pension plans).

Alternatively, if the conferees decide -- contrary to ERIC's recommendation -- to adopt the Senate bill's investment option rule, a deferred compensation plan should be permitted to offer hypothetical investment options that are comparable to the actual investment options offered by the employer's qualified defined contribution plan covering the greatest number of workers (excluding workers covered by collective bargaining agreements). Such a rule would be more equitable and workable than the rule that currently appears in the Senate bill.

In addition, if the conferees decide to adopt the Senate bill's investment option rule -- which they should not -- the conferees should at least postpone the effective date of the rule until the Treasury issues guidance on how to determine whether a hypothetical investment option is "comparable" to an actual investment option. The Senate bill does not define "comparable," and until that term is defined, employers will be unable to design their plans with any confidence that they are complying with the investment option rule. Congress should not impose a rule on employers until they are given the guidance they need to comply with the rule.

Finally, if the investment option rule is retained -- which it should not be -- the bill should provide for a substantial transition period following mergers and acquisitions, since (as explained earlier) the array of investment options offered by the employer's qualified plans will change frequently as a result of such events. *See* IRC § 409A(a)(3) under S. 1637.

7. <u>Prescribe practical rules for elections governing distributions triggered by a severance from employment</u>: Both S. 1637 and H.R. 4520 generally require a participant in a nonqualified deferred compensation plan to elect the time and schedule of payment before the beginning of the year in which the deferred compensation is earned. Both bills provide that, except as provided in regulations, no acceleration of the time or schedule of payment is permitted, and both bills impose highly restrictive conditions on any delay in the time or schedule of payment. It is unreasonable to require a participant to specify, perhaps 20 or 30 years before severance from employment (for example, because of retirement, death, or disability) how and when distributions will be made at that uncertain future time. The conference bill should permit participants' elections affecting the time and schedule of payment that are triggered by severance from employment (including retirement, death, and disability) to become effective if they are made at least one year before severance from employment. An election made at least one year before severance from employment with respect to payments

triggered by the severance would not be subject to the 5-year delay or other restrictions that apply to most election changes. Such a one-year rule will assure that participants do not have ready access to their deferred compensation, but will not subject them to unduly rigid and wholly impractical restrictions. *See* IRC § 409A under S. 1637; IRC § 409A under H.R. 4520.

8. Accommodate fiscal year and multi-year bonus plans: Both S. 1637 and H.R. 4520 provide that an initial election to defer compensation must be made before the beginning of the first taxable year of the participant in which the services are performed. This requirement has an unduly restrictive effect on elections to defer bonuses that are payable under fiscal year plans, multi-year plans, and plans under which bonuses are not payable until well after the end of the participant's taxable year. For example, under a fiscal year plan, a deferral election would have to be made as much as two years before the bonus is payable; and in the case of a plan under which bonuses are paid on the basis of a three-calendar-year period, a deferral election would have to be made more than three years before the bonus is payable, at a time when it is impossible to make even a rough estimate of the amount of the bonus. These severe restrictions can be corrected, without compromising the bills' objectives, by providing that an initial deferral election must be made *at least six months before the earliest date on which the bonus is payable*. *See* IRC § 409A(a)(5)(B) under S. 1637; IRC § 409A(a)(4)(B) under H.R. § 4520.

9. Permit a global employer to use a single rabbi trust for the deferred compensation of its global employees: S. 1637 excludes from its offshore trust provision any "assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such jurisdiction." H.R. 4520 does not contain a similar exclusion. Although the objective of the exclusion is laudable, the wording of the exclusion suggests that a global company that frequently transfers employees from county to country could not maintain a single trust for the deferred compensation of all of its global employees, but would have to establish a separate trust in each jurisdiction in which its employees work and determine each year where "substantially all" the services of each employee were performed. The serious practical problems created by the exclusion are compounded by the fact that some countries do not have well-developed trust laws and others do not even recognize trusts as legal entities. The exclusion should be modified to exclude assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed outside of the United States. *See* IRC § 409A(b)(1) under S. 1637.

10. Clarify the "no acceleration" rule: Both S. 1637 and H.R. 4520 provide that, except as provided in regulations, a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of payments. The conferees should make clear that the anti-acceleration provision applies only to *elective* accelerations and that it does not forbid plan provisions providing for *automatic* acceleration when certain events occur (for example, a plan provision that states that even if payments are being made in installments, the participant's remaining account balance is automatically distributed in a lump sum following the participant's death or termination of employment or a plan provision that states that a participant is automatically cashed out in a lump sum following plan termination or if a separated participant's account balance is less than a specified amount). This point might be clarified in the legislative

history or by providing in the conference bill that, except as provided in regulations, acceleration is not permitted other than by reason of separation from service, disability, death, change in ownership or control, unforeseeable emergency, automatic cashout provisions, or plan termination. *See* IRC § 409A(a)(4) under S. 1637; IRC § 409A(a)(3) under H.R. 4520.

11. Eliminate either the six-month rule or the "Catch 22" created by the six-month rule: Under both S. 1637 and H.R. 4520, a nonqualified deferred compensation plan must provide that a key employee of a public company may not receive a distribution on account of separation from service before the expiration of six months following separation from service. Because the bills already impose sufficient restrictions on the receipt of deferred compensation, the six-month rule is unnecessary and should not be included in the conference bill. However, if, contrary to ERIC's recommendation, the six-month rule is retained, the bill should include an exception to the six-month rule for mandatory employment and income tax withholding (under federal, state, or local law). Otherwise, for example, a key employee who participates in a supplemental retirement plan will be taxed (and subject to mandatory withholding) for FICA purposes at retirement (under IRC § 3121(v)(2)), but not allowed to receive the funds from which the tax must be withheld until six months later. Similar problems can arise under state or local tax laws that do not defer tax on deferred compensation. Moreover, if FICA tax (or state or local income tax) is withheld in these circumstances, the employee presumably will be deemed to have received a distribution from the plan for federal income tax purposes -- which will be subject to federal income tax withholding. Congress should not put taxpayers in this "Catch 22" situation. *See* IRC § 409A(a)(2)(B)(i) under S. 1637; IRC § 409A(a)(2)(B)(i) under H.R. 4520.

12. Address deferrals of commission income: Both S. 1637 and H.R. 4520 provide that an initial election to defer compensation must be made before the beginning of the first taxable year of the participant in which the services are performed. It is unclear how this requirement applies (if at all) to deferrals of commission income because, in the case of commission income, it is difficult, if not impossible, to relate a commission payment to the performance of specific services. Commissions differ markedly from salary and bonuses because they depend in large part on the actions of a third-party over time: executing a contact, renewing a contract, taking delivery, not canceling the contract, making payment, etc. As a result, the rules that apply to deferrals of salary and bonuses should be modified to address the quite different circumstances that apply to deferrals of commissions. *See* IRC § 409A(a)(5)(B) under S. 1637; IRC § 409A(a)(4)(B) under H.R. § 4520.

13. Accommodate limited mid-year reductions in, or cessations of, deferrals under voluntary deferral plans: Both S. 1637 and H.R. 4520 provide that an initial election to defer compensation must be made before the beginning of the first taxable year of the participant in which the services are performed. This requirement would appear to be violated if an employee is permitted to make a mid-year election to reduce or cease his or her deferrals under a voluntary deferral plan. However, many events -- including, but not limited to, unforeseeable emergencies -- may subject an employee to unreasonable hardship unless reductions or cessations of deferrals are permitted. For example, a court might issue an order requiring the employee to make a large payment of alimony or child support; in such circumstances, a reduction or cessation of deferrals might be necessary to allow the employee to comply with the

order. The conferees should allow mid-year reductions in, or cessations of, deferrals under voluntary deferral plans in these and comparable circumstances. *See* IRC § 409A(a)(5)(B) under S. 1637; IRC § 409A(a)(4)(B) under H.R. § 4520.

14. Direct the Treasury to issue "model, snap-on amendments": In view of (a) the potentially abbreviated period of time between the date of enactment and the effective date of the deferred compensation provisions, (b) the many unresolved questions that the conference bill is likely to raise, and (c) the severe penalties for noncompliance, the conferees should direct the Treasury to facilitate compliance in the near term by issuing "model, snap-on amendments" that employers can adopt in time to avoid inadvertent formal violations of the new provisions.