D. Nonqualified Deferred Compensation Plans

1. Treatment of nonqualified deferred compensation plans (sec. 671 of the House bill, section 671 of the Senate amendment, and new sec. 409A and secs. 6040 and 6051 of the Code)

Present Law

In general

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[795] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare taxes when the compensation is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). Amounts deferred under a nonaccount balance plan that are not reasonably ascertainable are not required to be taken into account as wages subject to social security and Medicare taxes until the first date that such amounts are reasonably ascertainable. Social security and Medicare tax treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[796] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial

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[795] *See, e.g.*, *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

[796] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451.[797] Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Rabbi trusts

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[798] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

[797] Treas. Reg. secs. 1.451-1 and 1.451-2.

[798] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

The IRS has issued guidance setting forth model rabbi trust provisions.[799] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which attempt to allow deferred amounts to be available to individuals, while still purporting to meet the safe harbor requirements set forth by the IRS.

House Bill

Under the House bill, all amounts deferred under a nonqualified deferred compensation plan[800] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[801] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. Actual or notional earnings on amounts deferred are also subject to the provision.

Under the provision, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control in a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and may not permit acceleration of a distribution, except as provided in regulations by the Secretary.

In the case of a specified employee, distributions upon separation from service may not be made earlier than six months after the date of the separation from service. Specified employees are key employees[802] of publicly-traded corporations.

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[799] Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

[800] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person.

[801] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

[802] Key employees are defined in section 416(i) and generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees),

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the provision. The provision requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

An unforeseeable emergency is defined as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant, the participant's spouse, or a dependent (as defined in 152(a)) of the participant; loss of the participant's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

A participant is considered disabled if he or she (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (ii) is, by reason on any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

As previously discussed, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. For example, changes in the form of a distribution from an annuity to a lump sum are not permitted. The provision provides the Secretary authority to provide, through regulations, limited exceptions to the general rule that no accelerations can be permitted. It is intended that exceptions be provided only in limited cases where the accelerated distribution is required for reasons beyond the control of the participant. For example, it is anticipated that an exception could be provided in order to comply with Federal conflict of interest requirements or court-approved settlements.

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five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

The provision requires that the plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. For example, it is expected that Treasury regulations provide that, in appropriate circumstances, elections to defer incentive bonuses earned over a period of several years may be made after the beginning of the service period, as long as such elections may in no event be made later than 12 months before the earliest date on which such incentive bonus is initially payable. The Secretary may consider other factors in determining the appropriate election period, such as when the amount of the bonus payment is determinable. It is expected that Treasury regulations will not permit any election to defer any bonus or other compensation if the timing of such election would be inconsistent with the purposes of the provision. Under the provision, in the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

The time and form of distributions must be specified at the time of initial deferral. A plan could specify the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in lump sum within 30 days of separation from service) or could allow participants to elect the time and form of payment at the time of the initial deferral election. If a plan allows participants to elect the time and form of payment, such election is subject to the rules regarding initial deferral elections under the provision.

Under the provision, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that in limited cases, the Secretary will issue guidance, consistent with the purposes of the provision, regarding to what extent elections to change a stream of payments are permissible.

If impermissible distributions or elections are made, or if the nonqualified deferred compensation plan allows impermissible distributions or elections, all amounts deferred under the plan (including amounts deferred in prior years) are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income. In addition, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture.

Under the provision, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets are located outside of the United States or at the time transferred if such assets are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. It is expected that the Secretary will provide rules for identifying the deferrals to which assets set aside are attributable, for situations in which assets equal to less than the full amount of deferrals are set aside. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Under the provision, a transfer of property in connection with the performance of services under section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan 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. The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. It is intended that the transfer of property occurs to the extent that assets are restricted or will be restricted with respect to such compensation. For example, in the case of a plan that provides that upon a change in the employer's financial health, a trust will become funded to the extent of all deferrals, all amounts deferred under the plan are treated as property transferred under section 83. If a plan provides that deferrals of certain individuals will be funded upon a change in financial health, the transfer of property would occur with respect to compensation deferred by such individuals. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[803] A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the provision.[804] Plans subject to section 457, other than governmental eligible deferred compensation plans, are subject to both the requirements of section 457 and the provision. For example, in addition to the requirements of the provision, an eligible deferred compensation plan of a tax-exempt employer would still be required to meet the applicable dollar limits under section 457.

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[803] A qualified employer plan also includes a section 501(c)(18) trust.

[804] A governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

Interest imposed under the provision is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the provision. The provision is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. Any amount included in gross income under the provision is not be required to be included in gross income under any provision of law later than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The provision requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 for the year deferred even if the amount is not currently includible in income for that taxable year. Under the provision, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonable ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[805]

The provision provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of provision, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the provisions providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture.

It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are used inconsistent with the purposes of the provision. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction.

<u>Effective date</u>.–The House bill is effective for amounts deferred after June 3, 2004. The provision does not apply to amounts deferred after June 3, 2004, and before January 1, 2005, pursuant to an irrevocable election or binding arrangement made before June 4, 2004. Earnings on amounts deferred before the effective date are subject to the provision to the extent that such amounts deferred are subject to the provision.

It is intended 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.

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[805] It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)-1(e)(4).

No later than 90 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which an individual participating in a nonqualified deferred compensation plan adopted before June 4, 2004, may, without violating the requirements of the provision, terminate participation or cancel an outstanding deferral election with regard to amounts earned after June 3, 2004, if such amounts are includible in income as earned.

Senate Amendment

The Senate amendment follows the House bill with the following modifications.

Under the Senate amendment, if the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 10-percent tax.

Under the Senate amendment, in the case of an individual who, with respect to a corporation, is subject to the requirements of section 16(a) of the Securities Act of 1934, distributions upon a change in control may not be made earlier than one year after the date of the change in control of the corporation. Such individuals include officers (as defined by section 16(a)),[806] directors, or 10-percent owners of publicly-held corporations. Under the provision, distributions made to such individuals within one year of the change in control ("applicable payments") are treated as excess parachute payments under section 280G (even if the payment would not otherwise be treated as an excess parachute payment) and therefore subject to the excise tax under section 4999. As under present law, no deduction is allowed for any amount treated as an excess parachute payment.

If, absent the provision, an applicable payment is a payment in the nature of compensation contingent on a change in control, section 280G is applied as if the provision had not been enacted (i.e., the applicable payments continue to be taken into account under section 280G). Any resulting excess parachute payment is also subject to the excise tax under section 4999 (in addition to the tax imposed by the provision). Under the provision, an applicable payment that, absent the provision, is not a payment in the nature of compensation contingent on a change in control is required to be taken into account in determining if the present value of the payments in the nature of compensation contingent on a change in control equal or exceed three times the base amount. Any resulting excess parachute payment is also subject to the excise tax under section 4999 (in addition to the tax imposed by the provision). Applicable payments do not include payments made upon death or if the participant becomes disabled. Treasury regulations shall prescribe rules to prevent a deduction from being disallowed more than once.

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[806] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

Under the Senate amendment, unforeseeable emergency also includes hardship of a beneficiary. Unforeseeable emergency is defined as severe financial hardship of the participant or beneficiary resulting from a sudden and unexpected illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse or the participant's or beneficiary's dependent (as defined in 152(a)); loss of the participant's or beneficiary's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary. Distributions are not allowed to the extent that the hardship may be relieved by liquidation of the participant's or beneficiary's assets.

Under the Senate amendment, participants must be limited to one subsequent election.

The Senate amendment includes restrictions on investment options. Under the Senate amendment, investment options (including phantom or notional investment options) which a participant may elect under the nonqualified deferred compensation plan must be comparable to those which may be elected by participants of the qualified defined contribution plan of the employer that has the fewest investment options. It is intended that the investment options of the nonqualified deferred compensation plan may be less favorable or more limited than those of the qualified defined contribution employer plan. The Committee intends that open brokerage windows, hedge funds, and investments in which the employer guarantees a rate of return above what is commercially available are prohibited. If there is no qualified defined contribution employer plan, the investment options of the nonqualified deferred compensation plan must meet the requirements prescribed by the Secretary regarding permissible investment options. It is intended that in cases where there is no such qualified defined contribution employer plan, the Secretary issue rules limiting the available investment options.

The Senate amendment includes an exception to the provision requiring assets set aside outside of the U.S. for purposes of paying deferred compensation to be treated as property transferred in connection with the performance of services. The provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The provision is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements.

The Senate amendment does not apply to a plan meeting the requirements of section 457(e)(12) if the plan was in existence as of May 1, 2004, and was providing nonelective deferred compensation described in section 457(e)(12) on such date. If the plan has a material change in the class of individuals eligible to participate in the plan after May 1, 2004, the exception does not apply to compensation provided under the plan after the date of such change.

The Senate amendment does not includes an exception from the reporting requirement for deferrals that are not reasonable ascertainable.

Effective date.–The provision is effective for amounts deferred in taxable years beginning after December 31, 2004.

Not later than 90 days after the date of enactment, the Secretary is directed to issue guidance providing a limited period during which an individual participating in a nonqualified deferred compensation plan adopted on or before December 31, 2004, may, without violating the provision, terminate participation or cancel an outstanding deferral election with regard to amounts earned after December 31, 2004, if such amounts are includible in income as earned.

Conference Agreement

In general

The conference agreement follows the House bill with the following modifications. Under the conference agreement, all amounts deferred under a nonqualified deferred compensation plan[807] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[808] and not previously included in gross income, unless certain requirements are satisfied.[809] If the requirements of the provision are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.[810]

Current income inclusion, interest, and the additional tax apply only with respect to the participants with respect to whom the requirements of the provision are not met. For example, suppose a plan covering all executives of an employer (including those subject to section 16(a) of the Securities and Exchange Act of 1934) allows distributions to individuals subject to section 16(a) upon a distribution event that is not permitted under the provision. The individuals subject to section 16(a), rather than all participants of the plan, would be required to include amounts deferred in income and would be subject to interest and the 20-percent additional tax.

[807] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person. Amounts deferred also include actual or notional earnings.

[808] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

[809] It is intended that Treasury regulations will provide guidance regarding when an amount is deferred. It is intended that timing of an election to defer is not determinative of when the deferral is made.

[810] These consequences apply under the provision to amounts deferred after the effective date of the provision.

Permissible distributions

In general

Under the provision, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (as determined by the Secretary), death, a specified time (or pursuant to a fixed schedule), change in control of a corporation (to the extent provided by the Secretary), occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations by the Secretary, may not permit acceleration of a distribution.

Separation from service

In the case of a specified employee who separates from service, distributions may not be made earlier than six months after the date of the separation from service or upon death. Specified employees are key employees[811] of publicly-traded corporations.

Specified time

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Change in control

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as is used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the provision. The provision requires the Secretary to issue guidance defining change of control within 90 days after the date of enactment.

Unforeseeable emergency

An unforeseeable emergency is defined as a severe financial hardship to the participant: (1) resulting from an illness or accident of the participant, the participant's spouse, or a dependent (as defined in sec. 152(a)); (2) loss of the participant's property due to casualty; or (3) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond

[811] Key employees are defined in section 416(i) and generally include officers having annual compensation greater than $130,000 (adjusted for inflation and limited to 50 employees), five percent owners, and one percent owners having annual compensation from the employer greater than $150,000.

the control of the participant. The amount of the distribution must be limited to the amount needed to satisfy the emergency plus taxes reasonably anticipated as a result of the distribution. Distributions may not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause a severe financial hardship).

Disability

A participant is considered disabled if he or she (1) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months; or (2) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the participant's employer.

Prohibition on acceleration of distributions

As mentioned above, except as provided in regulations by the Secretary, no accelerations of distributions may be allowed. In general, changes in the form of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions. However, it is intended that the rule against accelerations is not violated merely because a plan provides a choice between cash and taxable property if the timing and amount of income inclusion is the same regardless of the medium of distribution. For example, the choice between a fully taxable annuity contract and a lump-sum payment may be permitted. It is also intended that the Secretary provide rules under which the choice between different forms of actuarially equivalent life annuity payments is permitted.

It is intended that the Secretary will provide other, limited, exceptions to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the control of the participant and the distribution is not elective. For example, it is anticipated that an exception could be provided if a distribution is needed in order to comply with Federal conflict of interest requirements or a court-approved settlement incident to divorce. It is intended that Treasury regulations provide that a plan would not violate the prohibition on accelerations by providing that withholding of an employee's share of employment taxes will be made from the employee's interest in the nonqualified deferred compensation plan. It is also intended that Treasury regulations provide that a plan would not violate the prohibition on accelerations by providing for a distribution to a participant to pay income taxes due upon a vesting event subject to section 457(f), provided that such amount is not more than an amount equal to the income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the participant under section 457(f). It is also intended that Treasury regulations provide that a plan would not violate the prohibition on accelerations by providing for automatic distributions of minimal interests in a deferred compensation plan upon permissible distribution events for purposes of administrative convenience. For example, a plan could provide that upon separation from service of a participant, account balances less than $10,000 will be automatically distributed (except in the case of specified employees).

<u>Requirements with respect to elections</u>

The provision requires that a plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations.[812] In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period. It is not intended that the provision override the constructive receipt doctrine, as constructive receipt rules continue to apply. It is intended that the term "performance-based compensation" will be defined by the Secretary to include compensation to the extent that an amount is: (1) variable and contingent on the satisfaction of preestablished organizational or individual performance criteria and (2) not readily ascertainable at the time of the election. For the purposes of the provision, it is intended that performance-based compensation may be required to meet certain requirements similar to those under section 162(m), but would not be required to meet all requirements under that section. For example, it is expected that the Secretary will provide that performance criteria would be considered preestablished if it is established in writing no later than 90 days after the commencement of the service period, but the requirement of determination by the compensation committee of the board of directors would not be required. It is expected that the Secretary will issue guidance providing coordination rules, as appropriate, regarding the timing of elections in the case when the fiscal year of the employer and the taxable year of the individual are different. It is expected that Treasury regulations will not permit any election to defer any bonus or other compensation if the timing of such election would be inconsistent with the purposes of the provision.

The time and form of distributions must be specified at the time of initial deferral. A plan could specify the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in lump sum within 30 days of separation from service) or could allow participants to elect the time and form of payment at the time of the initial deferral election. If a plan allows participants to elect the time and form of payment, such election is subject to the rules regarding initial deferral elections under the provision. It is intended that multiple payout events are permissible. For example, a participant could elect to receive 25 percent of their account balance at age 50 and the remaining 75 percent at age 60. A plan could also allow participants to elect different forms of payment for different permissible distribution events. For example, a participant could elect to receive a lump-sum distribution upon disability, but an annuity at age 65.

Under the provision, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow a subsequent election to delay the timing or form of distributions only if: (1) the plan requires that

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[812] Under the provision, in the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible.

such election cannot be effective for at least 12 months after the date on which the election is made; (2) except in the case of elections relating to distributions on account of death, disability or unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) the plan requires that an election related to a distribution to be made upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. It is expected that in limited cases, the Secretary will issue guidance, consistent with the purposes of the provision, regarding to what extent elections to change a stream of payments are permissible. The Secretary may issue regulations regarding elections with respect to payments under nonelective, supplemental retirement plans.

Foreign trusts

Under the provision, in the case of assets set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under section 83 (whether or not such assets are available to satisfy the claims of general creditors) at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. Any subsequent increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts set aside been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

It is expected that the Secretary will provide rules for identifying the deferrals to which assets set aside are attributable, for situations in which assets equal to less than the full amount of deferrals are set aside. The provision does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The provision is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Triggers upon financial health

Under the provision, a transfer of property in connection with the performance of services under section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan 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. An amount is treated as restricted even if the assets are available to satisfy the claims of general creditors. For example, the provision applies in the case of a plan that provides that upon a change in financial health, assets will be transferred to a rabbi trust.

The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. It is intended that the transfer of property occurs to the extent that assets are restricted or will be restricted with respect to such compensation. For example, in the case of a plan that provides that upon a change in the employer's financial health, a trust will become funded to the extent of all deferrals, all amounts deferred under the plan are treated as property transferred under section 83. If a plan provides that deferrals of certain individuals will be funded upon a change in financial health, the transfer of property would occur with respect to compensation deferred by such individuals. The provision is not intended to apply when assets are restricted for a reason other than change in financial health (e.g., upon a change in control) or if assets are periodically restricted under a structured schedule and scheduled restrictions happen to coincide with a change in financial status. Any subsequent increases in the value of, or any earnings with respect to, restricted assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

Definition of nonqualified deferred compensation plan

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.[813] A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[814] A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b)) is also a qualified employer plan under the provision. A tax-exempt or governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan. The application of the provision is not limited to arrangements between an employer and employee.

For purposes of the provision, it is not intended that the term "nonqualified deferred compensation plan" include an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future. The provision is not intended to change the tax treatment of incentive stock options meeting the

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[813] The provision does not apply to a plan meeting the requirements of section 457(e)(12) if the plan was in existence as of May 1, 2004, was providing nonelective deferred compensation described in section 457(e)(12) on such date, and is established or maintained by an organization incorporated on July 2, 1974. If the plan has a material change in the class of individuals eligible to participate in the plan after May 1, 2004, the provision applies to compensation provided under the plan after the date of such change.

[814] A qualified employer plan also includes a section 501(c)(18) trust.

requirements of 422 or options granted under an employee stock purchase plan meeting the requirements of section 423.

It is intended that the provision does not apply to annual bonuses or other annual compensation amounts paid within 2 ½ months after the close of the taxable year in which the relevant services required for payment have been performed.

Other rules

Interest imposed under the provision is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the provision. The provision is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. Any amount included in gross income under the provision is not be required to be included in gross income under any provision of law later than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

Treasury regulations

The provision provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of provision, including regulations: (1) providing for the determination of amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the provisions providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture. It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are used in a manner inconsistent with the purposes of the provision. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction. The Secretary may also address in regulations issues relating to stock appreciation rights.

Aggregation rules

Under the provision, except as provided by the Secretary, employer aggregation rules apply. It is intended that the Secretary issue guidance providing aggregation rules as are necessary to carry out the purposes of the provision. For example, it is intended that aggregation rules would apply in the case of separation from service so that the separation from service from one entity within a controlled group, but continued service for another entity within the group, would not be a permissible distribution event. It is also intended that aggregation rules would not apply in the case of change in control so that the change in control of one member of a controlled group would not be a permissible distribution event for participants of a deferred compensation plan of another member of the group.

Reporting requirements

Amounts required to be included in income under the provision are subject to reporting and Federal income tax withholding requirements. Amounts required to be includible in income are required to be reported on an individual's Form W-2 (or Form 1099) for the year includible in income.

The provision also requires annual reporting to the Internal Revenue Service of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 (or Form 1099) for the year deferred even if the amount is not currently includible in income for that taxable year. It is expected that annual reporting of annual amounts deferred will provide the IRS greater information regarding such arrangements for enforcement purposes. It is intended that the information reported would provide an indication of what arrangements should be examined and challenged. Under the provision, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirement does not apply. The Secretary may also provide that the reporting requirement does not apply with respect to amounts of deferrals that are not reasonably ascertainable. It is intended that the exception for amounts not reasonable ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.[815]

Effective date

The provision is effective for amounts deferred in taxable years beginning after December 31, 2004. Earnings on amounts deferred before the effective date are subject to the provision to the extent that such amounts deferred are subject to the provision.

Amounts deferred in taxable years beginning before January 1, 2005, are subject to the provision if the plan under which the deferral is made is materially modified after October 3, 2004. The addition of any benefit, right or feature is a material modification. The exercise or reduction of an existing benefit, right, or feature is not a material modification. For example, an amendment to a plan on November 1, 2004, to add a provision that distributions may be allowed upon request if participants are required to forfeit 10 percent of the amount of the distribution (i.e., a "haircut") would be a material modification to the plan so that the rules of the provision would apply to the plan. Similarly, accelerating vesting under a plan after October 3, 2004, would be a material modification. A change in the plan administrator would not be a material modification. As another example, amending a plan to remove a distribution provision (e.g., to remove a "haircut") would not be considered a material modification.

Operating under the terms of a deferred compensation arrangement that complies with current law and is not materially modified after October 3, 2004, with respect to amounts deferred before January 1, 2005, is permissible, as such amounts would not be subject to the requirements of the provision. For example, subsequent deferrals with respect to amounts deferred before January 1, 2005, under a plan that is not materially modified after October 3,

[815] It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)-1(e)(4).

2004, would be subject to present law and would not be subject to the provision.[816] No inference is intended that all deferrals before the effective date are permissible under present law. It is expected that the IRS will challenge pre-effective date deferral arrangements that do not comply with present law.

For purposes of the effective date, an amount is considered deferred before January 1, 2005, if the amount is earned and vested before such date. To the extent there is no material modification after October 3, 2004, present law applies with respect to vested rights.

No later than 60 days after the date of enactment, the Secretary shall issue guidance providing a limited period of time during which a nonqualified deferred compensation plan adopted before December 31, 2004, may, without violating the requirements of the provision relating to distributions, accelerations, and elections be amended (1) to provide that a participant may terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, if such amounts are includible in income of the participant as earned, or if later, when not subject to a substantial risk of forfeiture, and (2) to conform with the provision with respect to amounts deferred after December 31, 2004. It is expected that the Secretary may provide exceptions to certain requirements of the provision during the transition period (e.g., the rules regarding timing of elections) for plans coming into compliance with the provision. Moreover, it is expected that the Secretary will provide a reasonable time, during the transition period but after the issuance of guidance, for plans to be amended and approved by the appropriate parties in accordance with this provision.

2. Denial of deferral of certain stock option and restricted stock gains (sec. 672 of the Senate amendment and sec. 83 of the Code)

Present Law

Section 83 applies to transfers of property in connection with the performance of services. Under section 83, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property over the amount (if any) paid for the property is includible in income at the first time that the property is transferable or not subject to substantial risk of forfeiture.

Stock granted to an employee (or other service provider) is subject to the rules that apply under section 83. When stock is vested and transferred to an employee, the excess of the fair market value of the stock over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

The income taxation of a nonqualified stock option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value. If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient

[816] There is no inference that all subsequent deferral elections under plans that are not materially modified are permissible under present law.

exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise.

Other forms of stock-based compensation are also subject to the rules of section 83.

House Bill

No provision.

Senate Amendment

Under the Senate amendment, gains attributable to stock options (including exercises of stock options), vesting of restricted stock, and other compensation based on employer securities (including employer securities) cannot be deferred by exchanging such amounts for a right to receive a future payment. Except as provided by the Secretary, if a taxpayer exchanges (1) an option to purchase employer securities, (2) employer securities, or (3) any other property based on employer securities for a right to receive future payments, an amount equal to the present value of such right (or such other amount as the Secretary specifies) is required to be included in gross income for the taxable year of the exchange. The provision applies even if the future right to payment is treated as an unfunded and unsecured promise to pay. The provision applies when there is in substance an exchange, even if the transaction is not formally structured as an exchange.

The provision is not intended to imply that such practices result in permissive deferral of income under present law.

<u>Effective date</u>.–The Senate amendment applies to exchanges after December 31, 2004.

Conference Agreement

The conference agreement does not include the Senate amendment.