ERIC

The ERISA Industry Committee

Advocating the Employee Benefits Interests of America's Largest Employers

1400 L Street, N.W., Suite 350, Washington, D.C. 20005

phone (202)789-1400 / fax (202)789-1120 / e-mail <eric@eric.org>

www.eric.org

October 11, 2004

NONQUALIFIED DEFERRED COMPENSATION LEGISLATION

NOTE: House Report language described in chart is included in Conference Report Statement of Managers unless noted otherwise.

PROVISION	HOUSE & SENATE BILLS (H.R.4520, S.1637)	CONFERENCE AGREEMENT (H.R.4520)
Employment Tax Exclusion for Stock Options	• House bill excludes remuneration attributable to the exercise of an incentive stock option or under a qualified employee stock purchase plan from wages for employment and income tax withholding purposes.	• Includes the House provision at Section 251.
Withholding Rule	• Senate bill increases wage withholding to highest rate on supplemental wage payments to an employee to the extent the payments exceed $1 million.	• Includes Senate provision at Section 904, effective for payments made after 12/31/04.
Conflict of Interest Rule	• Under the Senate bill, the sale of shares of stock pursuant to the exercise of a statutory stock option by officers and employees of the Executive Branch of the Federal Government in compliance with Federal conflict of interest requirements is treated as satisfying the statutory holding period and afforded capital gain treatment eligible for deferral treatment under section 1043. The employer is not allowed a deduction upon the sale of the stock.	• Includes the Senate provision at Section 905, effective for sales after the date of enactment.
Tax Basis Rules for Nonresident Aliens	• Senate bill excludes employee or employer contributions from basis if the employee is a nonresident alien, the compensation is for labor or services from sources outside the United States, and the contribution was not subject to US or foreign income taxes.	• Includes the Senate provision – with several modifications – at Section 906, effective for distributions on or after the date of enactment.

Denial of Deferral of Stock Option & Restricted Stock Gains	● Under the Senate bill (Sec. 972), gains attributable to stock options, vesting of restricted stock, and other compensation based on employer securities cannot be deferred by exchanging such amounts for a right to receive a future payment.	● Does not include Senate provision. However, the Stmt of Mgrs specifies that under the bill, NQDC will not include an arrangement taxable under section providing for the grant of an option on employer stock only if the "exercise price...is not less than the fair market value of the underlying stock on the date of grant [and] such arrangement does not include a deferral feature other than the feature that the option holder hs the right to exercise the option in the future."
NQDC Provisions - In General	● House & Senate bills: New Internal Revenue Code (IRC) section 409A establishes requirements under which amounts, including earnings, deferred under a nonqualified deferred compensation (NQDC) plan and subject to a substantial risk of forfeiture will not be taxed immediately.	● Same as House and Senate, with modifications noted below. (Sec. 885)
Effective Date for NQDC Provisions	● House bill: Amounts deferred after 6/3/04 except those deferred prior to 1/1/05 pursuant to an irrevocable election or binding arrangement made prior to 6/3/04. ○ House Report subjects subsequent elections with respect to amounts deferred prior to 6/3/04 to the bill. ● Senate bill: Amounts deferred after 12/31/04 ● Both bills: Termination or cancellation of elections made prior to effective date permitted under regulations.	● Amounts deferred after 12/31/04 so long as plan not materially modified after 10/3/04 except to conform to regulations allowing termination or cancellation of elections for amounts deferred after 12/31/04. These regulations are due within 60 days after enactment. The Stmt of Mgrs: ○ Defines material modification; ○ Defines amounts deferred before 1/1/05 as amounts earned and vested before such date; ○ States that bill does not apply to such vested rights; ○ Clarifies that regulations may provide exceptions to rules (e.g., regarding timing of elections) during transition period. ○ Expects regulations to provide a reasonable time after issuance of guidance for plans to be amended. ● House Report language regarding subsequent elections deleted.

<table>
<tr><td>Definition of NQDC</td><td>Both bills: <u>Any</u> plan or arrangement providing for the deferral of compensation that is not
A qualified employer plan as described in IRC sec. 219(g)(5),
A bona fide vacation, sick leave, compensatory time, disability pay, or death benefit plan, or
One of certain 457 plans.</td><td>Same, except
Provisions regarding government and 457 plans modified.
Aggregation rules apply.
Stmt of Mgrs clarifies that bill does not apply to
Arrangements taxable under IRC sec. 83 providing for stock option with an exercise price not less than the fair market value of the stock on the date of the grant if the arrangement does not include deferral features other than the right to excercise the option.
Incentive stock options under IRC sec. 422 or employee stock purchase plans under sec. 423;
Bonuses or 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.
Stmt of Mgrs specifies that, “issues relating to stock appreciate rights” may be addressed in regulations.</td></tr>
<tr><td>Penalties for Noncompliance</td><td>Both bills provide that if a NQDC plan fails to meet <u>any</u> of the bill’s requirements, either in form or operation, <u>all</u> compensation deferred under the plan by <u>all participants</u>, for the taxable year and all preceding taxable years, including interest at the underpayment rate plus 1%, is includible in gross income.
Senate bill: 10% additional tax also applied.</td><td>Same, except that
Amounts includible in gross income limited to “participants with respect to whom the failure relates.”
Additional tax is 20%.
Stmt of Mgrs example: A violation with respect to an individual subject to sec. 16(a) would cause all participants subject to 16(a), but not other participants, to be subject to immediate taxation.</td></tr>
</table>

Restrictions on Timing of Deferral Elections	● House bill: Except as provided in regulations, initial election must be made during taxable year preceding year in which the services are performed or within 30 days if taxpayer becomes eligible during the year. ○ House Report provides that multi-year incentive bonus elections may be made no later than 12 months before the earliest date on which the bonus is payable, and regulations may consider other factors such as when the amount of the bonus payment is determinable. ○ House Report states that time and form of distribution must be provided at initial deferral. ● Senate bill: Same, but does not include House Report language regarding multi-year bonuses.	● Same as House bill, except that, in the case of performance-based compensation, such election must be made no later than 6 months before the end of the service period. The Stmt of Mgrs -- ○ Defines performance-based compensation as: - Variable and contingent on the satisfaction of preestablished criteria and not readily ascertainable at the time of election; - With exceptions, subject to rules similar to IRC sec. 162(m). ○ Provides for regulations for fiscal year plans; ○ Clarifies that multiple payout events are permissible; ○ Specifies that "The Secretary may issue regulations regarding elections with respect to payments under nonelective, supplemental retirement plans."
Restrictions on "Subsequent Elections"	● House bill: Subsequent elections to delay the timing or change the form of payment (1) cannot take effect until 12 months after the date of the election, (2) must provide for an additional deferral of at least 5 years (except for death, disability, or unforeseeable emergency), (3) for distributions at a specified time or pursuant to a fixed schedule, must be made 12 months in advance of the first payment. ○ Regulations are to determine to what extent elections to change a stream of payments will be allowed. ● With limited exceptions for circumstances beyond the control of the participant, no acceleration of payments is permitted. ● Senate bill: Same except one subsequent election is permitted with respect to an amount deferred.	● Same as House bill except that Stmt of Mgrs specifies that "The Secretary may issue regulations regarding elections with respects to payments under nonelective, supplemental retirement plans." ● See also discussion of acceleration prohibition in section in this chart on "Restrictions on Distributions".
Restrictions on Investment Options	● Senate bill: Investment options in a NQDC plan are restricted to those available under the qualified defined contribution plan of the employer with the fewest investment options.	● Not included in the bill.

Restrictions on Distributions	● House bill: Distributions permitted only upon: ○ Separation from service (as determined in regulations); ○ disability (participant must have a medically determinable impairment expected to last 12 months or result in death, or by reason of such impairment, be receiving benefits for at least 3 months under employer's accident and health plan); ○ death; ○ a specified time or pursuant to a fixed schedule specified in the plan or at the date of deferral; - House report clarifies that amounts payable upon the occurrence of an event (e.g., when the participant's child starts college) are not treated as amounts payable at a specified time. ○ a change in ownership or control of the corporation or, in the ownership of a substantial portion of the assets of the corporation (regulations to be issued within 90 days after enactment); - House report states definition of change of control is to be more restrictive than that in IRC sec. 280G; ○ an unforeseeable emergency affecting the participant or certain family members and resulting in severe financial harship. ● As noted above, acceleration of payments is prohibited. ○ House Report states that compliance with Federal conflict of interest requirements or court-approved settlements are examples where acceleration should be allowed. ● Payments to "key employees" (IRC sec. 416(i)) of a publicly traded corporation may not be made in the first six months following the individual's separation from service.	● Generally the same as House bill, except ○ Payment to key employee allowed sooner than six months in the case of death. ● Stmt of Mgrs specifies that: ○ Acceleration prohibition 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 (e.g., a choice between a fully taxable annuity contract and a lump sum payout). ○ Regulations should also determine when choice between different forms of actuarially equivalent life annuity payouts is permitted. ○ Regulations should provide that a plan will not violate the prohibition on acceleration by providing that the employee's share of employment taxes will be withheld from his/her interest in the NQDC. ○ Regulations should provide for automatic distributions of minimal interests (e.g. $10,000) in a NQDC plan for administrative convenience.

	• Senate bill: Generally the same except ○ Payments to participants subject to sec. 16(a) during the one year period following a change in control are treated as excess parachute payments subject and subjected to a 20% excise tax, except in cases of death or disability; ○ Unforeseeable hardship includes hardship of beneficiary.	
Foreign Trusts	• House bill: Assets set aside in or transferred to a foreign trust are treated as transfers of property under IRC sec. 83 whether or not available to satisfy claims of creditors. (Thus, participants would be immediately taxed on such amounts when no longer subject to a substantial risk of forfeiture.) Tax imposed includes interest at the underpayment rate plus 1%. ○ House Report allows regulations to exempt arrangements that do not result in an improper deferral of US tax and that will not result in assets being effectively beyond the reach of creditors. • Senate bill: Same, except also includes ○ An exception for assets in a foreign trust if substantially all the services to which the NQDC relates are performed in such jurisdiction; ○ A 10% additional tax.	• Same as Senate bill except additional tax is 20%
Employer's Financial Health	• House bill: A transfer of property under IRC sec. 83 occurs if the assets are or, under the plan will be, restricted to the payment of NQDC upon a change in the employer's financial health. Tax imposed includes interest at the underpayment rate plus 1%. • Senate bill: Same except an additional 10% tax is imposed.	• Same, except additional tax is 20% and transfer of property occurs whether or not assets are available to satisfy claims of general creditors. Stmt of Mgrs clarifies that: ○ Provision applies, for example, to a plan that provides that upon a change in financial health assets will be transferred to a rabbi trust. ○ Provision does not apply when assets are restricted for reasons other than change in financial health e.g., upon a change in control) or when assets periodically are restricted under a structured schedule and such restrictions happen to coincide with a change in financial status.

Regulations	• House bill: Regulations shall include: ○ Determination of amounts of deferral where the NQDC plan is a defined benefit plan; ○ Distributions in connection with changes in the ownership and control of a corporation or assets of a corporation ; ○ Exempting foreign trusts that do not result in an improper deferral and that do not result in assets being beyond the reach of creditors; ○ Defining changes in financial health; and ○ Disregarding a substantial risk of forfeiture. - House Report states substantial risk of forfeiture may not be used to manipulate the timing of income inclusion. ○ 90 days after enactment, guidance is due - On what constitutes a change in ownership or effective control; and - Providing a limited period during which an individual may terminate participation in or cancel an outstanding deferral. • Senate bill: Generally the same.	• Same except ○ Regulations regarding period to terminate or cancel an election due in 60 days. ○ Stmt of Mgrs specifies that "The Secretary may also address in regulations issues relating to stock appreciation rights."
Reporting	• House bill: Deferred amounts are required to be reported to the IRS as part of an individual's W-2 form for the year deferred unless such amounts are below a minimum threshold or are not reasonably ascertainable. ○ Reasonably ascertainable exception is to be similar to that under Treas. Reg. 31.3121(v)(2)-1(e)(4). • Senate bill: Same	• Same as House bill.