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MEMORANDUM TO CLIENTS

Re: Nonqualified Deferred Compensation Proposals in New International Tax Bill

On July 25, Ways and Means Committee Chairman Bill Thomas (R-CA) introduced a corporate and international tax reform bill (H.R. 2896). Included among its many international and corporate tax reforms is a series of revenue-raising proposals to change the nonqualified deferred compensation rules. Significantly, the proposals in Chairman Thomas' international tax reform bill – unlike the proposals in an earlier Senate-passed version of this year's tax bill – would have no impact on –

- the use of rabbi trusts;
- the ability of participants to exercise investment control; or
- the deferral of gains attributable to stock options or restricted stock.

The proposals are also less far-reaching than the proposals in the international tax reform bill introduced by Chairman Thomas last year.

In general, sec. 1091 of the new bill would add a new Internal Revenue Code ("Code") section 409A under which amounts deferred under a nonqualified deferred compensation plan (including earnings) would be taxed immediately (except to the extent subject to a substantial risk of forfeiture) unless certain requirements are satisfied. Interest at the underpayment rate plus one percent would apply to amounts required to be included in income because of a failure to satisfy these requirements. The new requirements would apply to amounts deferred after December 31, 2003, and would apply to all nonqualified plan participants, not just corporate insiders.

Among other things, new Code sec. 409A would –

- permit distributions only upon –

- separation from service,
- death,
- disability (within the meaning of the Social Security Act),
- a specified time (or pursuant to a fixed schedule),
- a change in ownership or effective control of the corporation or in the ownership of a substantial portion of its assets, to the extent provided in Treasury regulations, and
- an unforeseeable emergency (under standards similar to the "unforeseeable emergency" requirements in the final Code section 457 regulations);

- prohibit the acceleration of payments before the specified time or schedule chosen at the time of deferral (which would eliminate the use of so-called "haircut" provisions);
- provide that payments to certain "specified employees" (defined generally as "key employees" under the Code section 416(i) top-heavy rules, which would include up to 50 officers of a publicly traded corporation) may not be made in the first six months following the individual's separation from service;
- require that initial deferral elections be made before the beginning of the taxable year in which the compensation is earned or at such other time as provided in regulations (with a special 30-day election period for newly eligible participants);
- require that any subsequent election to delay the timing or form of payment be made at least 12 months prior to the date of the scheduled distribution, and provide an additional deferral for a period of at least five years from the date of the election;
- in general, immediately tax amounts deferred (including earnings) under an arrangement that includes a financial distress trigger or where assets are held in an offshore trust, except as provided in Treasury regulations for arrangements that will not result in the improper deferral of tax or the assets being effectively beyond the reach of creditors; and
- require annual reporting to the IRS of deferred amounts as part of an individual's Form W-2 for the year deferred.

Under the bill, a "nonqualified deferred compensation plan" is defined generally as any plan or arrangement 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 (with no exception for severance plans). The Secretary of Treasury is directed to issue regulations to carry out these new rules, including regulations on the treatment of nonqualified defined benefit plans.

The new bill introduced by Chairman Thomas would also –

- permanently exclude from FICA and FUTA amounts realized on the exercise of incentive stock options (ISOs) and employee stock purchase plans (ESPPs); and

- provide an 8-year extension (to December 31, 2013) of the Code section 420 rules allowing transfers of excess pension assets to retiree health accounts.

It is not yet clear when (or if) the Ways and Means Committee will act upon this bill. A competing measure introduced by Reps. Phil Crane (R-IL) and Charles Rangel (D-NY) (H.R. 1769) has garnered over 135 co-sponsors, and there has been some speculation that the Thomas bill does not yet have adequate support to pass the Committee. Nevertheless, the new Thomas bill indicates that significant tax changes affecting deferred compensation are still very much in play.