

June 25, 2004

MEMORANDUM TO CLIENTS

Re: Update on Nonqualified Deferred Compensation Legislation

Significant changes to the rules that apply to nonqualified deferred compensation arrangements have been pending in Congress as part of Enron-related pension legislation and corporate and international tax reform legislation. Over the last month so, Congressional action on the corporate and international tax reform legislation containing the deferred compensation amendments has picked up steam.

As previously reported, the Senate passed its version of corporate and international tax reform legislation (S. 1637, the "Jumpstart Our Business Strength (JOBS) Act of 2004") by a vote of 92-5 on May 11. On June 14, the House Ways and Means Committee approved a new version of its corporate and international tax reform legislation (H.R. 4520, the "American Jobs Creation Act of 2004"), including a slightly-modified version of the nonqualified deferred compensation amendments contained in the version of the legislation (H.R. 2896) approved by the Ways and Means Committee last year. The House passed H.R. 4520 by a vote of 251-178 on June 17.

The pending changes are far-reaching and would have a dramatic effect on a wide variety of compensation arrangements, including many arrangements that traditionally have not been considered to involve deferred compensation as such. Moreover, the proposed changes would take effect almost immediately, with little or no transition time for employers and employees to modify their arrangements. Under the current effective date, the legislation would even be retroactive by applying the deferral election-timing requirements to existing bonus and long-term incentive arrangements. Other key issues that hopefully will be addressed in conference include –

- The term "nonqualified deferred compensation plan" is defined so broadly that the proposed requirements would apply to arrangements that do not involve voluntary participant deferral elections, including supplemental defined benefit pension arrangements, and many other common practices (e.g., annual bonuses; severance arrangements; stock options; restricted stock; restricted stock units; stock appreciation rights; phantom stock). IRS regulations ultimately could narrow the scope of the provisions, such as by excluding most plans subject to the rules of section 83.

- Initial deferral elections generally would be required to be made before the beginning of the taxable year in which the services are performed giving rise to the compensation. This would particularly affect the timing of deferral elections with respect to annual bonuses payable after the end of the taxable year and payments under multi-year long-term incentive plans (although Ways and Means report language directs Treasury to provide some flexibility with respect to bonus payments earned over several years).
- Under the Senate legislation, amounts deferred under nonqualified plans that permit employees to elect how earnings are credited to a bookkeeping account would be immediately taxable unless the investment options offered are comparable to those available under the employer's 401(k) plan.
- Under the Senate legislation, gains attributable to stock options, vesting of restricted stock, employer securities, or any other property based on employer securities transferred to the taxpayer, could not be deferred by electing to instead receive deferred amounts.

A conference committee to resolve differences between the House and Senate versions of the legislation has not yet been formed – and conferees have not been named – because of substantive and procedural hurdles unrelated to the deferred compensation amendments. As a result, conference negotiations on the legislation will not begin until after Congress returns from the July 4 recess.

It remains to be seen whether corporate and international tax reform legislation including the nonqualified deferred compensation amendments will be enacted this year. Possible obstacles to final action on the legislation include disputes over certain controversial provisions included in the House and Senate bills and the extent to which the legislation must be "paid for" with revenue-raising provisions. Moreover, very few legislative days remain before the November election. Nevertheless, the recent House and Senate action on the legislation significantly increase the chances that far-reaching changes in the nonqualified deferred compensation area will be made this year.

An updated side-by-side comparing the nonqualified deferred compensation changes in the House and Senate-passed bills is attached. This also reflects comments on issues clarified in the House Ways and Means Committee report on H.R. 4520 and in the recently-released Senate Finance Committee report on Enron-related pension reform legislation.