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Counsel

Buchanan Ingersoll PC
Gerald H. Sherman
Stuart M. Lewis
Deborah M. Beers
Norma Sharara
PricewaterhouseCoopers
William Archer
Donald Carlson

Federal Policy Group
Ken Kies
Patrick J. Raffaniello
Timothy Hanford
Jim Carlisle
Ricchetti Inc.
Steve Ricchetti
Jeff Ricchetti

AALU

Executive Vice President
David J. Stertzner

Director of Government Affairs
Tom Korb

Assoc. Dir. of Gov. Affairs
Marc R. Cadin

2901 Telestar Court
Falls Church, VA 22042
Phone: (703) 641-9400
Fax: (703) 641-9885
www.aalu.org

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Subject: **House Ways and Means Committee Approves The American Jobs Creation Act Including New Deferred Compensation Rules**

Major References: [*Description of H.R. 4520, The "American Jobs Creation Act of 2004," Prepared by the Staff of the Joint Committee on Taxation \(dated June 10, 2004\); portion explaining the deferred compensation provisions \(Section VI\(D\)\(1\); pgs. 226-232\)*](#)

Prior AALU Washington Reports: 04-82; 04-77; 04-64

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Late last night (June 14, 2004), the House Ways and Means Committee approved, by a bi-partisan vote of 27-9, the American Jobs Creation Act of 2004 ("AJCA") (H.R. 4520), which includes new nonqualified deferred compensation rules similar to those included in the Jumpstart our Business Strength Act ("JOBS") (S. 1637) that was approved by the full Senate on May 11, 2004 (see our Bulletins Nos. 04-82, 04-77 and 04-64). The next step is consideration of AJCA by the House, which may occur as early as this Friday (June 18, 2004) or sometime early next week. Following expected approval by the House, the two bills would have to be reconciled by a conference committee, a process certain staffers on the Hill believe may be completed as early as the end of July.

The two bills are primarily focused on the repeal of the U.S. export tax regime in response to a 2002 World Trade Organization ruling. Until that repeal is accomplished, certain U.S. exports will be subject to escalating sanctions from the European Union. Because of these political and economic factors, it is likely that this legislation will be enacted in this session of Congress. In addition, because the nonqualified deferred compensation provisions have been scored as generating almost \$900 million in revenue over a 10-year period, it is likely that, if the export bills are passed, they will include those provisions.

Although the deferred compensation treatments in the two bills are similar, there are a number of significant differences which will have to be reconciled in the conference committee (see our Bulletin No. 04-82). In addition, the AJCA includes a retroactive effective date (i.e., generally applicable to

compensation deferred after June 3, 2004) and the JOBS bill would generally be effective beginning in 2005. These effective date provisions could create significant compliance issues for existing arrangements.

In connection with the House Ways and Means Committee's consideration of AJCA, the Joint Committee on Taxation ("JCT") issued an explanation which "clarified" certain aspects of the proposed legislation.

For example, as passed by Ways and Means, the AJCA is generally effective for compensation deferred after June 3, 2004. In addition, unlike the JOBS bill, the AJCA includes a grandfather rule which provides that the new rules would 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. The JCT explanation indicates that amounts "further deferred" under a subsequent election will be subject to the new rules. As a result, deferred compensation that would not be subject to the new rules because it was deferred before the general effective date (or pursuant to a grandfather election) would lose its "grandfather" treatment if the compensation is re-deferred to a later date. It is not necessarily clear what "further deferred" may mean in all cases for this purpose. For example, if a current arrangement allows participants to select the form of distribution at some point in the future (e.g., between a lump sum and installments), it is not clear whether the election of installments would be considered a further deferral. In addition, it is not clear whether other modifications to an arrangement would jeopardize its grandfather status.

Furthermore, the two bills would require that the initial deferral election must generally be made before the calendar year in which the services are performed. Although the proposed legislation does not expressly address when the time and form of distributions must initially be specified, the JCT explanation provides that such designations must be made at the time of the initial deferral. As a result, participants will no longer be able to elect the form of distribution at a later date (e.g., one year prior to the scheduled commencement date). However, the proposed legislation expressly allows participants to "change" the timing and form of distribution so long as the change is made at least 12 months prior to the first scheduled payment date and the new payment date is extended at least 5 years.

Any AALU member who wishes to obtain a copy of the [JCT explanation](#) may do so through the following means: (1) use hyperlink above next to "major reference," (2) log onto the AALU website at www.aalu.org, enter the Members Portal with your social security number and select Current Washington Report for linkage to source material; (we are no longer using the Fax-on-Demand system) or (3) write to AALU, Attention [DeLane Jones](#), 2901 Telestar Court, Falls Church, Virginia 22042-1205, and include a reference to this Washington Report No. 04-85.



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D. Nonqualified Deferred Compensation Plans

1. Treatment of nonqualified deferred compensation plans

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,⁴⁰⁹ 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). This 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 83.⁴¹⁰ 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 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

⁴⁰⁹ 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.

⁴¹⁰ Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

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 451.⁴¹¹ 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.⁴¹² 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.

The IRS has issued guidance setting forth model rabbi trust provisions.⁴¹³ 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.

⁴¹¹ Treas. Reg. secs. 1.451-1 and 1.451-2.

⁴¹² 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).

⁴¹³ Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

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.

Description of Proposal

Under the proposal, all amounts deferred under a nonqualified deferred compensation plan⁴¹⁴ for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture⁴¹⁵ and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the proposal 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 proposal.

Under the proposal, 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 employees⁴¹⁶ of publicly-traded corporations.

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.

⁴¹⁴ A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person.

⁴¹⁵ 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.

⁴¹⁶ 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.

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 proposal. The proposal 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 proposal 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.

The proposal 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. 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 proposal.

Under the proposal, 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 shall issue guidance, consistent with the purposes of the proposal, 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 proposal, 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. The Secretary has authority to exempt arrangements from the proposal 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 proposal, 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.⁴¹⁷ A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the proposal.⁴¹⁸ Plans subject to section 457, other than governmental eligible deferred compensation plans, are subject to both the requirements of section 457 and the proposal. For example, in addition to the requirements of the proposal, an eligible deferred compensation plan of a tax-exempt employer would still be required to meet the applicable dollar limits under section 457.

Interest imposed under the proposal 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 proposal. The proposal 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 proposal. Any amount included in gross income under the proposal shall not be required to be included in gross income under any provision of law later than the time provided in the proposal. The proposal does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The proposal 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 proposal, 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

⁴¹⁷ A qualified employer plan also includes a section 501(c)(18) trust.

⁴¹⁸ A governmental deferred compensation plan that is not an eligible deferred compensation plan is not a qualified employer plan.

ascertainable only apply to nonaccount balance plans and that amounts be required to be reported when they first become reasonably ascertainable.⁴¹⁹

The proposal provides the Secretary authority to prescribe regulations as are necessary to carry out the purposes of proposal, 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 proposals 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 proposal. 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.

Effective Date

The proposal is effective for amounts deferred after June 3, 2004. The proposal 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 proposal to the extent that such amounts deferred are subject to the proposal.

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 proposal.

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 proposal, 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.

⁴¹⁹ It is intended that the exception be similar to that under Treas. Reg. sec. 31.3121(v)(2)-1(e)(4).