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Proposed Legislation Focuses on Deferred Compensation of Executives

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In the wake of recent corporate scandals, Congress has been closely reexamining arrangements that give executives the ability to defer compensation and secure retirement benefits greater than those normally provided under qualified retirement plans.

The Joint Committee on Taxation proposed legislation for inclusion in the Jobs and Growth Reconciliation Tax Act of 2003 (the "2003 Tax Act") which would have provided for the immediate taxation of certain deferred compensation (the "Joint Committee Proposal"). However, the proposed legislation ultimately approved by the Senate Finance Committee and the Senate (the "Senate Proposal") differed substantially from the Joint Committee Proposal, in that it provided more severe restrictions, but generally limited them to individuals subject to the requirements of Section 16(a) of the Securities Act of 1934; i.e., officers,[1] directors and 10% owners of both private and publicly-held companies ("corporate insiders").

Although the 2003 Tax Act, ultimately enacted, contained nothing affecting deferred compensation, it can be expected that Congress will address this area and enact some form of legislation which is likely to incorporate some or all of the Joint Committee and/or Senate Proposals. This article discusses practices that apply under the current law in designing and implementing nonqualified deferred compensation plans for executives and the effect that the Joint Committee and Senate Proposals would have on those plans and the executives that participate in them.

Nonqualified Deferred Compensation Plans – Current Law and Practices

Generally, these plans permit executives to reduce current taxes by deferring the receipt of compensation for services rendered to a time in the future when they expect to be taxed at a lower tax rate. These plans may be designed to allow executives an annual election to defer a portion of their salary and/or bonus. They may also be designed to provide executives with retirement payments that supplement the retirement income that they receive from regular "tax qualified" plans. Many such plans allow participants to designate the investments in which their deferred compensation is considered to be invested for purposes of determining the earnings (or losses) with which they are credited.

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[1] 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.

Constructive Receipt. Such plans are designed to avoid the application of the doctrine of constructive receipt. Under this tax doctrine, compensation is taxed currently if it is credited to the individual's account, set apart, or otherwise made available, so that the individual may draw upon it at any time. Income is not constructively received if the taxpayer's control over its receipt is subject to substantial limitations or restrictions.

Over the years, the courts have taken a more expansive pro-taxpayer approach than the IRS in determining the circumstances under which a participant may make elections both as to the deferral of compensation and its payment, without triggering the application of the constructive receipt doctrine. As a result, plans often provide that the executive may elect prior to the date on which he or she is due to receive the payment, to further defer the receipt of the compensation and/or to change the form of payment (e.g., from a lump sum to installment payments).

Plans may permit in-service distributions due to unforeseeable emergencies that are beyond the control of the participant (e.g., unexpected illness). Some plans permit a participant to receive an in-service withdrawal at any time so long as the withdrawal results in a financial penalty such as forfeiture by the participant of 10% of the amount withdrawn (commonly referred to as a "haircut"). Plans may also provide other penalties for in-service withdrawals such as the suspension of the participant's right to defer compensation for twelve months following the withdrawal. The theory behind these penalties is that they impose substantial limitations on the participant's right to currently receive deferred compensation and that, accordingly, the constructive receipt doctrine should not apply.

Economic Benefit and Rabbi Trusts. Such plans must also be designed to avoid the application of the economic benefit doctrine. Under this tax doctrine, an employee who, in lieu of receiving cash compensation, receives something else of economic value, such as an irrevocable cash contribution by the employer to a trust that may be used only for purposes of paying deferred compensation to the employee,[2] would nevertheless be subject to immediate taxation.

In order to provide executives with more than a mere promise to pay deferred compensation in the future, these plans are often funded with "rabbi trusts." Under a rabbi trust arrangement, the trustee of the trust receives the assets contributed by the employer to support its deferred compensation obligation and must generally use the assets in the trust to pay the compensation deferred under the plan. However, in order to avoid the application of the economic benefit doctrine, a rabbi trust, which is treated as a grantor trust of the employer for tax purposes, must provide that if the employer becomes bankrupt or insolvent, the assets held in the trust are subject to the claims of the employer's creditors. [3]

In an effort to provide participants with a greater degree of security, some rabbi trusts have been designed to provide that upon the occurrence of certain events (e.g., a change of control or a change in the employer's financial condition) the assets held in the trust cease to be subject to the employer's creditors and may be used only to pay benefits to participants. Such an event thereby makes the funds taxable to the participants. In addition, some practitioners have advocated that rabbi trusts be established in or moved to foreign jurisdictions with asset protection laws that

[2] See Sproull v. Comm., 16 T.C. 244 (1951); and Treas. Reg. §1.83-3(e)
[3] See Rev. Proc. 92-64, 1992-2 C.B. 422

may provide greater protection from the claims of the employer's creditors than under trusts that are located in the United States.

Proposed Legislation

Joint Committee Proposal. Under the Joint Committee Proposal, amounts deferred by any employee under a plan would be immediately includible in the employee's income unless distributions can occur only upon:

- separation from service,[4]
- the incurrence of a disability (defined as the long-term inability to engage in any substantial gainful activity),
- death,
- a specified time,
- a change in control, or
- the incurrence of a severe financial hardship.

Amounts payable upon the occurrence of a specific event (e.g., when the employee's child begins college) would not be considered to be paid at a specified time. Distributions on account of severe financial hardship would generally be limited to extraordinary and unforeseeable circumstances beyond the employee's control, would not be allowed if they could be satisfied from insurance or the employee's assets and could not exceed the amount needed to satisfy the hardship plus taxes on such amount.

Participants now would be limited to making one election to delay the timing of the payment or change the form of payment with respect to previously deferred compensation. Such election would have to be made at least twelve months prior to the scheduled distribution and provide an additional deferral of at least five years. Elections to accelerate the payment of deferred compensation would not permitted under any circumstances (other than for severe financial hardship as discussed above).

Under the Joint Committee Proposal, amounts previously deferred through foreign rabbi trusts, or under plans that provide that upon a change in the employer's financial health, assets held under the trust may be used only to pay deferred compensation (i.e., rabbi trusts with financial triggers), would be immediately includible in the employees' income.

Under the Joint Committee Proposal, any deferral or distribution elections, or any funding methods that are not be consistent with the foregoing rules would result in immediate taxation as well as the application of underpayment interest penalties. All amounts deferred by employees under such plans would be required to be reported on Form W-2 for the year deferred, even if not currently includible in income for the taxable year in which the deferral occurs.

Senate Proposal. Under the Senate Proposal, any compensation deferred under a "funded" plan by an individual who is a “corporate insider” will become immediately taxable when such compensation is no longer subject to a substantial risk of forfeiture (i.e., when the right to receive

[4] Under the proposal, certain officers, shareholders and highly compensated employees who separate from service would have to wait six months to receive a distribution.

the compensation is not contingent upon the future performance of substantial services by the individual). A plan would be considered "funded" unless:

- the participant's rights to the compensation deferred under the plan are no greater than the rights of the employer's general creditors;
- all amounts directly or indirectly set aside for purposes of paying the deferred compensation, and all income attributable to such amounts, remain solely the property of the employer (without being restricted to the provision of benefits under the plan);
- the amounts set aside are available to satisfy the employer's general creditor's claims at all times (i.e., not merely after bankruptcy or insolvency); and
- the investment options that participants may elect under the plan are limited to the same as those available under the employer's qualified plan that has the fewest investment options.

Under this proposal, “corporate insiders” apparently would no longer be able to fund such plans through rabbi trusts.

The Senate Proposal further provides that a plan will be considered funded unless the deferred compensation becomes payable only upon separation from service, disability (same limited definition as under the Joint Committee Proposal), death, at a specified time or pursuant to a fixed schedule. Acceleration of the time of payment would not permitted for any reason, including severe financial hardship or change in control. As with the Joint Committee Proposal, under the Senate Proposal, if a plan were modified so that it would be considered to become funded, the amounts deferred by “corporate insiders” would be immediately be includible in their income.

Conclusion. It is likely that Congress will enact some form of deferred compensation legislation soon, particularly given the post-Enron political climate and the scrutiny that is currently being given to executives' retirement benefits. In the meantime, companies should reconsider the use of foreign rabbi trusts and rabbi trusts with financial triggers and may want to take a "wait and see" approach before implementing any new rabbi trust arrangements. Finally, given the fact that any legislation will likely result in restrictions on the ability of executives to accelerate the payment of compensation already deferred, as well as make deferred compensation more accessible to an employer's creditors, executives may wish to reevaluate the risks and benefits of entering into deferred compensation arrangements.