New York State Bar Association

NYSBA

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July 14, 2004

The Honorable Members of the Finance Committee of the U.S. Senate
The Honorable Members of the Committee on Ways and Means of the U.S. House of Representatives
The Honorable John W. Snow

Subject: Provisions of H.R. 4520 and S. 1637 Relating to the Taxation of Deferred Compensation

Ladies and Gentlemen:

I am writing on behalf of the New York State Bar Association Tax Section concerning certain aspects of Section 671 of H.R. 4520, the American Jobs Creation Act of 2004, and Sections 671 and 672 of S. 1637, the Jumpstart Our Business Strength (JOBS) Act, affecting the taxation of deferred compensation.[1] Both bills would impose new restrictions on a wide variety of common nonqualified deferred compensation arrangements, with severe penalties for noncompliance.

The purpose of this letter is to bring to your attention some ways in which the scope and effective dates of the bills are unclear, and to suggest ways to make the penalty mechanism of the bills more effective. We hope that these issues will be addressed in the House-Senate Conference to reconcile these provisions of the two bills.

Background and Summary of Recommendations.

Background. Section 132 of the Revenue Act of 1978 expressly forbids the Internal Revenue Service from developing rules relating to nonqualified deferred compensation plans of for-profit employers that depart from the law as in effect on February 1, 1978. As a result, for more than 26 years, the Internal Revenue Service's views on the tax treatment of such plans have been expressed only in Revenue Procedures, setting forth "safe harbor" guidance, and in its litigation positions, which

[1] The principal authors of this report are Max J. Schwartz and Karen G. Krueger. Helpful comments were also received from Kimberly Blanchard, Peter Blessing, Dickson Brown, William L. Burke, Peter L. Faber, George Ince, Jr., David Kahen, Michael Schler and Lewis R. Steinberg.

generally have not met with success in the courts. Employers and their advisors have struggled to understand what the relevant tax rules are, and a wide range of practices – some quite aggressively pro-taxpayer – has developed. The bills would establish specific rules for design and operation of these plans. In some respects, the new rules would eliminate practices that many responsible practitioners view as aggressive under current law; in many other respects they would eliminate practices that are not considered aggressive (for example, permitting employees to elect in advance to have deferred compensation paid upon a specified event before termination of employment, such as a child's enrollment in college). We do not propose to comment on these changes as a policy matter, but we have concerns about the effective date provisions, stemming from the fact that the new rules will change existing practices that are generally considered legitimate under current law.

Scope of New Rules. The bills are clearly intended to discourage perceived abuses in elective deferred compensation arrangements for senior corporate executives: the language in many places is tailored for elective arrangements under which individual accounts are maintained (that is, defined contribution plans). However, the new rules would apply to a much broader group of plans, including nonelective arrangements, defined benefit plans, and even (as discussed further below) stock appreciation rights ("SARs") and other equity-based compensation arrangements, and it is difficult in some cases to be sure how the effective date and transition rules of the bills are intended to affect these different arrangements. Furthermore, many large employers sponsor plans covering large numbers of employees and former employees that would be affected by these rules, so a large number of individual taxpayers would face immediate tax and penalties on deferred compensation if employers are unable to bring the affected plans into timely compliance with the new rules.

Recommendations. For the foregoing reasons, we believe that certain key provisions should be clarified, the transition provisions should modified, and the penalty provisions refined, lest the bills undermine legitimate expectations and contractual rights of a large number of participants, discourage certain desirable compensation techniques, and penalize employees who are not at fault, to the detriment of employees and shareholders alike. Our specific recommendations are summarized below.

1. Effective date and transition rules:

   (a) If the general effective date of the new provisions is June 3, 2004 (the effective date of Section 671 of H.R. 4520), then transitional relief until January 1, 2005, should apply *for plans in effect on June 3, 2004 that are not materially amended after June 3, 2004 (except to comply with the new rules).*[2] This may have been the intent of the transition provisions; however, as drafted, the June 3, 2004 effective date is impractical and already places many plans in violation of the new rules with no opportunity to cure.

   (b) To the extent that deferred compensation accrued as of the effective date under plans in existence on June 3, 2004, may be governed by the new rules because the plans permit further deferral elections, the Treasury Department should be authorized to provide transitional relief before application of the new rules to such compensation.

   (c) The effective date and transition rules should refer to *"amounts accrued or credited"* under a deferred compensation plan and *"attributable to services performed before"* the effective date, rather than by referring simply to "amounts deferred," which is inherently ambiguous.

2. Stock appreciation rights: It should be clarified that the new provisions do not result in different tax treatment for SARs as opposed to stock options.

3. Exchanges involving "employer stock": It should be made clear that Section 672 of S. 1637, relating to the exchange of stock options and restricted stock for a right to receive future payments, applies only to exchanges of equity compensation awards as to which compensation income has not yet been recognized, and that substitute arrangements that meet the requirements for deferral under Section 671 will not result in immediate taxation.

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[2] As futher discussed below, the Januray1, 2005 date assumes that legislation is enacted by the end of the third quarter of 2004 so employers will have sufficient lead time to freeze existing arrangements and implement other changes effective January 1, 2005.

4. Penalty provisions:

(a) The penalties should not be imposed when an employer makes a good-faith mistake in plan drafting or administration, so long as the mistake is promptly and fully corrected when it is discovered.

(b) If a plan is drafted in accordance with the new rules, but the employer operates it in a manner that does not comply, the penalties should be designed to ensure that neither the affected participant nor the employer benefits from the noncompliance, and not to punish all other participants. If the violation takes the form of an election to defer made later than permitted by the new rules, the election should be disregarded. If the violation takes the form of a distribution earlier than permitted, the affected participant should be subject to the penalties (and the employer could lose its corresponding tax deduction).

(c) In order to provide an effective deterrent to early payment of deferred compensation in anticipation of an employer's bankruptcy, the penalties on the employees in question should be more severe than the 10% penalty imposed by S. 1637; otherwise the provision will fail to fulfill its purpose in this context.

1. June 3, 2004 effective date and transition rules

There are three elements to the effective date and transition provisions of the bills: the general effective date; a limited exception under H.R. 4520 for certain irrevocable deferrals made before June 3, 2004; and a direction to the Treasury Department to provide limited transition relief for participants to opt out of certain elections made before the effective date. These provisions are unclear in a number of respects, and appear not to provide appropriate transition relief for many affected plans and arrangements. We discuss the provisions and the issues they present, recommend certain changes to address those issues, and then provide several specific examples of common deferred compensation arrangements to illustrate how the bills and our recommendations would work in practice.

Description of the Three Provisions:

General Effective Dates. Under Section 671(d)(1) of H.R. 4520, the new rules would apply to "amounts deferred after June 3, 2004" (S.

1637 uses December 31, 2004). However, the following statement in the report of the House Ways and Means Committee accompanying H.R. 4520 suggests that in fact, amounts deferred before that date will be subject to the new rules: "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 provision." This statement may have been aimed at arrangements under which participants can make serial elections to keep postponing the distribution of the same deferred compensation. However, there are many other, more common plan designs that involve "subsequent deferral elections," whether through affirmative elections (such as an election made in advance of the payout date to receive the compensation in a lump sum or installments) or by merely *not electing* to receive a payment under a plan provision that does not conform to the new rules (such as an election to receive a payment at any time, subject to forfeiture of 10 percent of the distributed amount).

Limited Exception for Certain Irrevocable Deferrals. Section 671(d)(2) of H.R. 4520 provides an exception to the June 3 effective date, stating the new rules "shall *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" (emphasis added). For reasons discussed below, the scope of this exception is extremely narrow. In fact, it appears to create a bifurcated effective date, under which (1) many plans that have been in existence for years could be subject to the new rules on June 4, 2004 in respect of all accumulated deferrals, because they are not "binding," but (2) certain amounts deferred between June 3, 2004 and January 1, 2005 would never be subject to the new rules.

Limited Transition Relief. Both H.R. 4520 and S. 1637 instruct the Treasury Department to issue guidance, within 90 days of enactment, under which participants in plans in effect on or before the relevant effective date (June 3, 2004 for the House bill and December 31, 2004 for the Senate bill) could terminate their participation or cancel an outstanding deferral election; however, this ability to opt out is limited to "amounts *earned* after [the effective date] if such amounts are *includible in income as earned.*" (emphasis added). As we read this provision, it provides no relief with respect to previously earned but deferred compensation, leaving the Treasury without authority to provide transitional relief for most

existing deferred compensation programs. [3] Instead, this provision seems targeted only at salary and bonuses payable during the period June 3 - December 31, 2004.

Issues Presented by the Effective Dates and Transitional Rules

Lack of Clarity: what is meant by "amounts deferred"? It is unclear how the transition rules would actually apply to many existing arrangements. The rules appear to have been written primarily for voluntary deferred compensation plans under which employees decide whether to defer compensation not yet fully earned and individual accounts are maintained for those who so elect. As explained above, however, the new rules apply to a much wider variety of other types of arrangements under which compensation is paid at a date later than when the related services are rendered. Under many of these arrangements, it is not clear when amounts should be considered to have been deferred for purposes of applying the effective dates and transition rules of the bills.[4]

Possible times, depending on the arrangement in question, include: (1) the time at which the employee elected deferral; (2) the time at which the employee's election to defer became irrevocable; (3) the time at which the compensation would be paid, absent the deferral; (4) the time at which the services being compensated were rendered; (5) the time at which the deferred compensation is accrued or credited to an account for the employee; (6) the time at which the employee's right to receive the compensation became vested; or (7) the first time at which the employee may elect to receive compensation that was mandatorily deferred by the employer. The substantive provisions of both bills generally appear to point to (4), the time at which the services being compensated were rendered, and appear to ignore all of the other possibilities, including when the compensation vests.[5] We have no fundamental objection to this

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[3] Thus, for example, a SAR granted before June 4, 2004 and currently exercisable would be subject to immediate taxation under these provisions with no opportunity to cure.

[4] For example, as we illustrate at the end of Section 1, there are several different times at which compensation may be considered deferred under a simple supplemental executive retirement plan ("SERP") which does not permit participants to elect to defer compensation or to receive it currently.

[5] By contrast, the statement of the House Ways and Means Committee report accompanying H.R. 4520 previously quoted suggests that the correct time – at least for the effective date provisions – is the first time at which an employee may elect, after the effective date, to receive the compensation previously deferred (similar to choice (7) in the text).

reading, as it provides a bright-line test. However, if the statutory language is not clarified, employers will find it extremely difficult to implement the necessary changes to their plans and administrative systems until the Internal Revenue Service provides interpretive guidance.

Administrative Difficulties. If it is necessary for employers to differentiate the treatment of deferred compensation based upon whether it is "deferred" (or "earned") before, on or after June 3, 2004, compliance will be difficult – and if compliance is required as of June 4, 2004, it will be impossible unless special relief for retroactive changes is provided. Deferred compensation arrangements typically are administered based upon a calendar year cycle, and upon the intervals at which a particular company makes payroll payments. A June 3, 2004 effective date bears no rational relation to these time periods. No records have been kept, and no systems are in place, to enable employers to implement instantaneously a June 3, 2004 cut-off date for establishing a participant's accrued benefit under a plan or for crediting salary or other compensation to deferred compensation accounts, so as to determine the extent to which it is subject to or exempt from the new rules. Moreover, employers will have to review and overhaul many existing arrangements in order to meet the new requirements after they become effective, a process that is time-consuming and requires careful thought and implementation.

As noted above, participation in plans that would be affected by the changes is not limited to a small number of senior executives; the deferred compensation arrangements of many large employers cover thousands of employees and retirees. Implementing changes to recordkeeping and reporting systems to deal with a mid-year, mid-month effective date would require extensive lead time and reversal of actions taken in the interim. We also do not believe it reasonable to expect employers to invest in the required systems overhauls and plan amendments before changes have become law.[6]

Problem of Instant Noncompliance. The transition rules as currently drafted do not appear to prevent many existing plans from being non-compliant as of June 4, 2004, with no ability to cure their

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[6] We also note that new W-2 reporting rules for deferred compensation would be imposed by the bills, and we question whether either the Internal Revenue Service or employers will be in a position to have new systems in place to accomplish this for the taxable year ending December 31, 2004, as required under H.R. 4520.

noncompliance. The penalty for failing to comply with the new rules, even for plans currently in existence, is immediate taxation of *all* participants. We believe that most employers that are faced with this result will feel compelled to make an immediate lump sum payment of all taxable amounts, including for participants who are already in pay status and commenced receiving their benefits as an annuity or in installments years ago.[7]

Employees electing to defer compensation make important decisions regarding whether, to what extent and for how long to defer compensation in reliance on the availability of the choices that are made available under plans designed by their employers in accordance with the employers' interpretation of the law in effect at the time of those decisions. To subject amounts earned in the past to a significantly more restrictive regime than any employee or employer could have anticipated when deferral decisions were being made seems to us to be neither fair nor sound tax policy.[8]

Thus, it is important to be sure that the transition rules allow employers time to bring their plans and systems into compliance and do not unintentionally sweep into the new regime arrangements put in place before June 3, 2004.

Recommendations:

If a general effective date of June 3, 2004 is considered to be necessary to avoid abuse, we recommend that the new rules not apply to:

- current compensation for which a deferral election was made before June 3, 2004, and

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[7] This would have unfortunate consequences. Aside from upsetting the expectations of participants relying on a stream of monthly retirement income and the expectations of employers about their cash flow demands, cashouts could subject payments to unintended state taxation that would not have been permissible otherwise under federal law (see section 114 of P.L. 104-95, the so-called pension source tax legislation precluding certain state taxation of payments received under certain plans or in annuity form or installments over 10 years).

[8] As noted above, employers and employees have for many years been operating in an environment in which the Internal Revenue Service has been expressly forbidden to develop rules in this area that depart from the law as in effect on February 1, 1978. See Section 132 of the Revenue Act of 1978.

- amounts accrued or credited under a deferred compensation arrangement before January 1, 2005,

in each case, only to the extent that:

- the amount in question represents compensation for services performed before January 1, 2005, and

- the election, accrual or credit was under a plan that was in existence on June 3, 2004, and is not materially amended after June 3, 2004 (other than to comply with the new rules).

We do not make any specific recommendations about how to determine (1) the amount of accrued benefits as of a particular date, (2) the amount of earnings attributable to accrued benefits, and (3) the time period of the services to which compensation relates. Given the broad variety of these plans affected by the new rules, we believe that this is properly left for the Treasury to decide in regulations. See the example headed "Defined Benefit SERP" below for an illustration of the range of issues these questions raise.

This recommendation is predicated on the assumption that the changes will be enacted not later than September 30, 2004, providing time for Treasury to issue guidance on the new rules and for employers to amend their plans, change their administrative systems and communicate the changes to participants. If this assumption proves incorrect, we would recommend substituting a later date for December 31, 2004 in our recommendation (while not necessarily changing the June 3, 2004, date). In any event, we request that consideration be given to providing additional time after enactment for employers to bring their plans into compliance, as is usually done when changes are made to the requirements for tax-qualified plans under the Internal Revenue Code (the "Code").

Post-effective date elections relating to grandfathered amounts. As noted above, the House Ways and Means report suggests that the new rules would apply to compensation earned and deferred before the effective date that may be "further deferred under a subsequent election" after the effective date of the new rules. If this approach is considered necessary as a policy matter by the conferees, we believe that some transition relief would be appropriate.

Because of the large diversity of plans and circumstances under which such "subsequent elections" can be made under plans currently in effect, we recommend that the authority already given to Treasury to provide transitional relief be expanded to cover the exact details and the appropriate period of time for this relief. For instance, a transition rule permitting each participant to make one election after the effective date under the terms of the plan in existence on June 3, 2004 and with respect to amounts accrued under the plan as of December 31, 2004 would both limit the potential for abuse and also give some recognition to legitimate participant expectations. For example, a supplemental executive retirement plan ("SERP") such as that described in our example below may allow participants to elect, shortly before retirement, whether to receive their retirement benefits in a lump sum or in installments, and the choice to take installment payments is in effect a "further deferral election"; we submit that it would be reasonable not to apply the new rules to such an election relating to benefits accrued as of December 31, 2004, so long as the plan is not materially amended in a manner that affects those accrued benefits (other than to comply with the new rules). On the other hand, more limited transitional relief might be appropriate for amounts credited as of December 31, 2004 under a plan that permits serial elections to keep postponing payment, for instance permitting participants to make only a single further deferral election under the pre-June 3, 2004 terms of the plan We also recommend that it be made clear that if a participant has the choice under a plan's pre-June 3 terms to elect an early payment of deferred compensation, the failure to make such an election will not itself constitute a "subsequent election" under which compensation is "further deferred."

Examples.

We provide below some concrete examples of how the proposed new rules and our recommendation would apply to common types of arrangements.

Defined Benefit SERP: Consider a SERP that supplements a defined benefit pension plan by providing the benefits that would be paid under the employer's tax-qualified plan if the limitations prescribed under the Code had not applied. For example, if the tax-qualified plan provides a benefit equal to 2% of final average pay per year of service, subject to the Code limitations, the SERP might provide a benefit equal to the excess of 2% of final average pay per year of service over the amount actually provided under the tax-qualified plan. Participation in this type of plan is

typically not elective, and the benefits accrue and vest according to the same formulae and other requirements as the tax-qualified plan. The tax-qualification rules of the Code require that participants be provided with the right to elect a lump sum or various annuity forms within 90 days prior to retirement and the right to change that election within the same 90-day period, and the forms of benefit under the SERP typically mirror those under the related tax-qualified plan. Most employers reserve the right to amend or terminate this type of plan at any time, so long as the value of participants' accrued benefits is not reduced retroactively.

Such a SERP is a "nonqualified deferred compensation plan" as defined in the bills. Although it complies with many of the new requirements, it does permit certain noncompliant distributions (such as distributions to key executives immediately upon termination of employment) and elections (such as the elections to take a lump sum or annuity benefits). Thus, unless this plan is either grandfathered or timely amended, all participants would be subject to current tax. Under H.R. 4520 as currently drafted, such relief is not available, because:

- The ability of participants who have not yet retired to elect the form of their benefit appears to mean that their benefits under the SERP are not grandfathered at all, because they can "further defer" their benefits by electing an annuity form of benefit rather than a lump sum.

- Participants have not elected to participate in the SERP, and the SERP is not irrevocable or binding as of June 3, 2004; thus, it is not protected by the limited grandfather rule of Section 671(d)(2) of H.R. 4520.

- Participants will not be able to take advantage of the limited "opt-out" transitional relief to be provided by Treasury under Section 671(f) for their SERP benefits that are considered "earned" on or before June 3, 2004 (even assuming they would wish to accelerate payment of their retirement benefits), as that relief will apply only to benefits under the SERP that are considered to have been earned *after* that date.

Assuming that any benefits under the SERP are grandfathered, the employer still will not know how to distinguish grandfathered from non-grandfathered SERP benefits without substantial additional guidance from

the Treasury Department. Is the amount "deferred" or "earned" as of a particular date determined by reference to accrued benefits or to vested accrued benefits as of the date in question? Should the amount be determined based on the participant's final average pay, measured as though the participant had terminated employment on that date, or should future compensation increases be taken into account? How are the "earnings" on this amount (which are also grandfathered) to be determined? Or is no amount "deferred" or "earned" within the meaning of the bills, because the participant made no election to participate? Even when the answers to these questions become clear, substantial work will be required to distinguish which benefits under the SERP are subject to the new rules and which are not.

Under our recommendations, the accrued benefit of each participant under the plan on December 31, 2004 would be grandfathered, provided that the plan was in effect on June 3, 2004 and not materially amended after that date, and provided that the plan complied with the requirements for transitional relief that Treasury promulgated. [9]

Bonus deferral election: Consider a typical incentive bonus arrangement, under which employees are told that they will earn a bonus, if and to the extent performance goals are met during a defined period of one year or several years, which will be paid upon completion of the performance period or at a later date, as elected by the employee. Many employers allow such deferral elections to be made after the performance period has begun but before the end of the performance period.

Under H.R. 4520, such deferrals would not be permitted for bonuses paid after June 3, 2004, unless the deferral election had been made by June 3, 2004, even if the performance period began before that date. This result may be considered harsh by some, particularly where the performance period began before January 1, 2004. However, our recommendations would not change this result, because:

- by definition, the employee will not have made an irrevocable deferral election by June 3, 2004; and

[9] As previously indicated, we make no recommendation as to how to determine this accrued amount, but the range of possible methods is limited by making clear that it is the accrued benefit (and not, for example, the vested benefit) that is relevant.

- since the employee's entitlement to the bonus is contingent on future events, it will not have been credited to, or accrued for the benefit of, the employee under a deferred compensation plan by June 3, 2004 (although the employer may have accrued some portion of the bonuses for financial reporting purposes).

2. <u>Stock appreciation rights</u>

We do not know whether the drafters of the bills intended that Section 671 of the bills would change the tax rules applicable to SARs or to cause them to be taxed differently from stock options. Since SARs are an increasingly popular (and, we believe, desirable) compensation technique, this point should be clarified. Companies can accomplish indirectly through options what they could accomplish directly and more simply using an SAR, and as explained below, SARs may be considered more beneficial to shareholders than options. Furthermore, we are not aware that any tax or other abuse associated with the use of SARs as opposed to stock options has been identified.

A SAR generally gives an employee the right to receive, upon exercise, a payment in cash or stock having a value equal to the "spread" between the fair market value of a specified number of shares of employer stock at the time of exercise and the "exercise price" of the SAR. Like stock options, SARs are usually subject to a vesting schedule and may be exercised during a specified term after they vest. Economically, SARs provide the same compensation to the employee as stock options with the same terms. In the past, SARs have been less popular than stock options because under generally accepted accounting principles, it has been possible for a company to avoid recognizing compensation expense for stock options, while SARs have resulted in charges to earnings. However, when the expected changes to the financial accounting rules for employee stock options become effective, options would also generate charges. This leveling of the playing field is expected to make SARs much more shareholder-friendly and cost-effective than options for employers to use, as the same compensation can be delivered to employees with less dilution of shareholders and without the need for employees to pay an exercise price out-of-pocket or to arrange for a simultaneous sale of shares to cover the exercise price. In addition, private companies often cannot offer stock options to employees because of securities law restrictions and the lack of liquidity for their stock; in such cases, cash-settled SARs are used to provide the same compensation as options.

Under current law, the taxation of SARs and options is also the same: the employee is not taxed when they vest, but rather recognizes compensation income at the time of exercise, equal to the "spread" between the fair market value of the underlying shares at the time of exercise and the exercise price. Under the bills, it appears that SARs would be viewed as a form of deferred compensation, with the result that the employee would be taxed upon vesting. We recommend that this issue be clarified either in the text of the final law or in the legislative history.[10]

3. Option and restricted stock exchanges

Under Section 672 of S. 1637, exchanges of stock options or employer securities "or any other property based on employer securities transferred to the taxpayer" for a right to receive future payments would require income recognition measured by the present value of such right. The reference to "employer securities" and the fact that the provision takes the form of an amendment to Section 83 of the Code suggest that it is intended to affect only exchanges involving options and other securities received as compensation. However, the provision refers to employer securities transferred "to the taxpayer" rather than "to an employee or other service provider." The current provisions of Section 83 shed no light on the meaning of the term "employer securities," neither defining nor even using the term.

The Code does contain a definition of the term "employer securities" in Section 409(l): it means "common stock issued by the employer (or by a corporation which is a member of the same controlled group)" that is either publicly traded or meets certain requirements for voting and dividend rights. This definition appears, however, to be both too broad, and too narrow to make sense in the context of Section 672: too broad, because it would cover common stock that was not transferred

[10] Under the new rules (if they apply to SARs), SARs would be taxable as soon as they vested, because the employee would have the ability to elect to receive the spread on the SAR at any time after vesting. Furthermore, unless our recommendations in Section 1 above are adopted, a SAR granted before the effective date of the new rules would appear to be subject to the new rules immediately upon becoming exercisable after June 3, 2004 (an event which may have already occurred), because the employee's decision not to exercise the SAR would be in effect an election to defer the compensation. The limited "opt-out" relief, if applicable on the theory that the SAR was a binding arrangement in effect on June 3, 2004, would be available to the employee only at the price of giving up the opportunity for further increase in the spread value of the SAR. In general, the transition rules as currently drafted do not seem apposite for SARs.

to "the taxpayer" in a compensatory context; and too narrow, because it would not cover all classes of stock that might be used by an employer as compensation.

To illustrate the possible reach of Section 672 as drafted, consider a business combination in which an acquiring company buys all the common stock of a target company from its shareholders in exchange for consideration delivered at closing, plus a right (contingent or otherwise) to receive future payments. (For example, such future payments might take the form of an installment sale, an earn-out arrangement under which the additional payments are computed based upon the post-closing performance of the target business, or a distribution of escrowed amounts that remain after satisfaction of any post-closing indemnification obligations.) We believe this provision was not intended to tax all shareholders on the present value of the entire consideration at the time of closing (possibly at ordinary income rates), whether or not the shareholder had received the option or employer security in the context of a compensatory arrangement. However, the statutory language could be clearer on this point.

Assuming that we are correct that the provision is intended to apply only to securities that employees of (or other providers of services to) the target company received from the company, we are still concerned that it makes no distinction between employees (or other service providers) who have already recognized taxable compensation for the employer securities and those who have not. For example, an employee who received restricted shares that vested before the purchase – who is considered, under current tax law, to have become an ordinary shareholder with respect to those shares – would appear to be treated the same way as an employee whose restricted shares remain subject to a substantial risk of forfeiture. Further, it would treat such employee shareholders in a manner inconsistent with other shareholders who are receiving the identical consideration.

We recommend that the provision be limited to exchanges of equity compensation awards that have not resulted in the recognition of compensation income before the exchange.

Even with this limitation, the provision would still discourage exchanges that may be in the best interests of employers and their shareholders. For example, if an exchange of unvested restricted stock of a target company for comparable restricted stock of an acquiring company

is taxable, it is likely that the companies would lift the restrictions, rather than subject employees to taxation on property that has not yet vested, thus sacrificing the retention incentive inherent in restricted stock. We do not know whether this result was intended to apply in the context of mergers, as opposed to voluntary exchanges in the ordinary course of employment. In any event, we would ask that consideration be given to modifying Section 672 so as not to tax the exchange of unvested equity awards for deferred compensation arrangements that comply with the income deferral provisions of Section 671.

4. Penalty Provisions

Both bills would impose substantial new requirements for the design of nonqualified deferred compensation plans. The enforcement mechanism for these new rules would be draconian: a failure to comply with the rules in any respect would cause all participants in the plan to be subject to immediate taxation, interest and penalties on all their vested deferred compensation under the plan.[11] We believe that this mechanism would be overly punitive in certain cases where the violation resulted not from a noncompliant plan design, but from the employer's noncompliant administration. At the same time, we are concerned that, as explained below, the penalty provisions would in fact not deter senior executives from causing the distribution of their deferred compensation on the eve of the employer's bankruptcy – one of the perceived abuses in the Enron scandal that inspired this legislation.

The new rules would forbid four basic practices: distributions of deferred compensation that are considered to occur too early; elections to defer that are considered to be made too late; allowing too broad a range of investment choices (Senate bill only); and protections against the risks of the employer's bankruptcy. We believe that the application of the penalty provisions to the first two categories of noncompliance should be refined to better deter the targeted practices. We also believe that the penalties should distinguish between the two ways in which a deferred compensation plan may violate the new rules: defects of plan design – where the written rules of the plan do not comply – and defects in plan operation – where the written rules of the plan are disregarded. For

[11] We note that in order to prevent circumvention of this penalty, the Treasury will need to adopt rules for aggregation of separate plans and individual arrangements by the same employer.

example, if a plan expressly provides that participants may receive distributions upon request, subject to forfeiting 10% of the amount distributed, the plan does not comply with the new rules by virtue of a design defect. On the other hand, if the plan purports to forbid such distributions, but in practice senior executives are permitted to receive them, the noncompliance is an operational defect.

It seems likely that the proposed penalties will deter early distributions and late elections that are expressly permitted by the terms of deferred compensation plan documents. Well-informed employers typically try to ensure that their plans are drafted taking into account applicable tax laws to achieve their purpose of tax deferral. In our view, the reason many plans currently permit practices that may be considered overly aggressive or abusive is that for the past 26 years, no clear rules have been provided by statute or regulation. Thus, we expect that if the bills are enacted and the Internal Revenue Service promulgates clear interpretive regulations, most employers will attempt in good faith to conform their plan documents to the new rules. However, because the rules are both new and complex, we expect that employers will nonetheless make good faith errors, particularly during the initial period after enactment, while they and their advisors (and the Internal Revenue Service) are still attempting to understand the new rules. Hence, as discussed below, we recommend some relief for good-faith errors.

On the other hand, the penalties are not well-tailored to deter operational defects, which would most likely occur by mistake or by selective actions favoring senior executives. Under the bills, if an employer permitted a single impermissible distribution of deferred compensation to, or a late election by, a single participant – even by mistake – all participants in the plan would be subject to immediate taxation on all of their vested deferred compensation under the plan, with interest and a penalty (10 percent under S. 1637 and 1 percent under H.R. 4520). This result seems unfair for participants who have no control over the administration of the plan and do not benefit from the violation.

The dilemma is familiar to those who practice in the area of qualified plans. The rules governing Section 401(a) plans are so complex that even sophisticated, well-advised employers often fail to operate them properly in minor respects, either through a lack of clarity in the rules themselves or because of administrative errors; yet the penalty for noncompliance – disqualification of the entire plan – is so onerous for plan participants that the Internal Revenue Service has been reluctant to impose

it. Instead, the Service has developed a series of procedures for voluntary corrections to be made by employers who discover their own mistakes. Unless the penalty provisions are modified, the bills would perpetuate this pattern of excessively complicated regulation and overly punitive enforcement measures by extending it into the area of nonqualified deferred compensation; absent a similar program for correction of mistakes, a large number of individual taxpayers could be penalized for their employers' difficulties in complying with the new rules.

Moreover, the bills do not make any attempt to penalize the employer, which will by definition have been responsible for the plan's defects of design or operation. The consequence of accelerating the taxation of the employees' income recognition is to accelerate the time for the employer's tax deduction. If the compensation is payable to a top executive, Section 162(m) of the Code might disallow the deduction in whole or in part, but in many cases the acceleration will actually benefit, rather than penalize, the employer.

Finally, the penalty provisions are unlikely to deter senior executives from "taking the money and running" in the face of bankruptcy. Even if a deferred compensation plan provides that distributions are to be made only as permitted by the bills, senior executives may agree with the employer to take early distributions. In ordinary circumstances, the prospect of triggering interest and penalties for themselves might discourage this practice (although we think it is unfair to impose the same sanction on participants who are not in a position to obtain such distributions). However, if senior executives expect that their employer is headed into bankruptcy, they are highly likely to determine that interest and even a 10 percent penalty are a price worth paying to avoid losing all of their deferred compensation to the employer's creditors.

Recommendations:

Allow for correction of good-faith mistakes. An employer's good-faith mistake in plan drafting or administration that is promptly and fully corrected upon discovery should not result in any penalties.

Target penalties for operational noncompliance at the responsible parties. We would apply different penalties for different types of operational noncompliance:

- *Early Distributions.* If an employer makes distributions that are impermissibly early, notwithstanding a compliant plan design, the recipient – but not other participants – should be subject to the penalties (and the employer could lose its tax deduction for the recipient's deferred compensation), unless the distribution results from a good faith mistake and is corrected promptly.

- *Special Rule for Bankruptcies.* Consideration should be given to imposing a higher penalty, perhaps even at confiscatory levels, on an employee who receives a noncompliant distribution within a certain period before the employer's bankruptcy (such as one year). In this situation, employees are unlikely to be deterred even by a 10 percent penalty, and the employer is unlikely to care about loss of its deduction. The excise tax provisions of Section 4975 may provide a useful model in this regard.

- *Late Elections.* If an employer allows deferral elections that are impermissibly late, notwithstanding a compliant plan design, the election should be treated as null and void, and the employee in question should be subject to tax at the time the compensation would have been paid, absent the election.

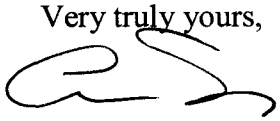
    - In some cases, this will have occurred through a good faith mistake, and refusing to respect the deferral will be a sufficient sanction.

    - However, in order to deter abuses (such as repeated instances of noncompliance), the Internal Revenue Service should have the discretion to apply interest and penalties to the affected compensation, or to disallow the employer's deduction for it, or both.

* * * * *

We appreciate your consideration of these comments. If we can be of any further assistance to you or your staffs with respect to these matters, we would welcome the opportunity to do so.

Very truly yours,



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