NEWS

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Congress Considering Far-Reaching Executive Deferred Compensation Legislation

With the dust still settling after the passage of the Sarbanes-Oxley Act of 2002, which was signed into law on July 30, 2002, Congress is now considering two bills that, if enacted, would significantly impact the vast majority of nonqualified deferred compensation arrangements. The bills, the "American Competitiveness and Corporate Accountability Act of 2002" (H.R. 5095), introduced on July 11, 2002 by House Ways and Means Committee Chair Bill Thomas (R-CA), and the "National Employee Savings and Trust Equity Guarantee Act of 2002" (S. 1971), approved by the Senate Finance Committee on the same day, have thus far received strong bi-partisan support, and are likely to garner more support as the public and the press continue to scrutinize executive compensation arrangements, particularly with Congress focused on upcoming elections.

The American Competitiveness and Corporate Accountability Act of 2002 ("ACCAA")

As currently proposed, ACCAA would add a new section to the Internal Revenue Code of 1986, as amended, that would require that covered officers, directors, and shareholders who defer compensation under "funded" nonqualified deferred compensation plans (unless maintained by a tax-exempt entity) include deferred amounts in gross income in the first taxable year in which there is no substantial risk of forfeiture (i.e., when the amounts vest).

When Would a Plan be Considered "Funded"

A plan would be considered funded under ACCAA, unless all of the following conditions are met:

- The employee's rights to the compensation are no greater than the rights of general creditors;
- Compensation deferred under the plan is only payable upon separation from service, death, or at a specified time (or pursuant to a fixed schedule);
- The plan does not permit the acceleration of the time such deferred compensation is payable (for any event);
- All amounts set aside under the plan remain solely the property of the employer (without being restricted to the provision of benefits);
- All amounts are available to satisfy the claims of the employer's general creditors at all times (not merely after bankruptcy or insolvency); and
- If a trust is used in connection with a plan, there is no factor that would make it more difficult for general creditors to reach the assets in the trust than it would be if the trust assets were held directly by the employer in the U.S.

As such, the following common arrangements and plan provisions could make amounts deferred after the effective date of the new law taxable upon vesting:

- "Rabbi" trusts;
- Offshore trusts;
- Equity split-dollar life insurance arrangements;
- Plan provisions
  - early distributions upon a change of control;

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– early distributions due to a disability;
– early distributions due to a hardship;
– "haircut" arrangements (i.e., where a participant agrees to forfeit a percentage of his or her benefit in exchange for an early distribution); or
– subsequent deferral elections (i.e., where a participant elects to further defer previously-deferred amounts).

Who is Covered

ACCAA would cover anyone subject to Section 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act")—generally officers, directors, and 10% beneficial owners—as well as those who would be subject to that section if the corporation were a publicly-traded corporation.

Effective Date of Proposed Legislation

The bill would apply to compensation deferred after July 10, 2002. Thus, if you are considering adopting a new deferred compensation arrangement or intend to make deferrals under an existing arrangement, you should take into account the potential impact of ACCAA due to its retroactive application. For example, if you use a "rabbi" trust in conjunction with an existing deferred compensation arrangement, it may be best to adopt a "wait and see" approach prior to making any further contributions to the trust.

National Employee Savings and Trust Equity Guarantee Act of 2002 ("NESTEG")

As currently proposed, NESTEG targets many of the same executive deferred compensation arrangements affected by ACCAA. Unlike ACCAA, however, NESTEG would apply to all employees—not just to individuals who are subject to Section 16(a) of the Exchange Act or those that would be subject to the Exchange Act if the corporation were a publicly-traded corporation—and would require subsequent action by the Department of Treasury (the "Treasury"), making retroactive application unlikely.

NESTEG would repeal Section 132 of the Revenue Act of 1978, which preserved the current tax treatment of nonqualified deferred compensation arrangements and limited the Treasury's ability to issue guidance with respect to such arrangements. According to the Senate Finance Committee's report, it is intended that the Secretary of the Treasury issue guidance on the tax treatment of nonqualified deferred compensation arrangements, focusing on arrangements that "improperly defer income."

Examples of issues and arrangements intended to be addressed by the Secretary of Treasury include:

- What is considered a substantial limitation under the constructive receipt doctrine, and situations in which an individual's right to receive compensation is, at least in form, subject to substantial limitations, but in fact is not so limited;
- Arrangements that purport to be unfunded, but should be treated as funded;
- Arrangements in which assets, technically, appear to be subject to the claims of an employer's general creditors, but, practically, are not;
- The ability to receive funds on account of financial hardship;
- The use of trusts or other arrangements under which the rights of general creditors to gain access to funds is limited;
- The use of triggers and third-party guarantees to fund arrangements; and
- "Haircut" provisions.

Other Aspects of NESTEG

In addition to authorizing the Treasury to issue guidance with respect to nonqualified deferred compensation practices, NESTEG also includes provisions that would

- Treat assets located outside the United States (such as in an offshore trust) that are designated or are otherwise available for the payment of nonqualified deferred

compensation as not subject to the claims of creditors for purposes of determining whether there is a transfer of property under Section 83 of the Internal Revenue Code of 1986, as amended (unless substantially all of the services to which the compensation relates are performed in the same jurisdiction as the trust);

- Treat direct or indirect loans to officers, directors, and 5% owners (and loans to any employee in excess of $1 million) made after the date of enactment—including loans made in connection with a split-dollar life insurance arrangement, but excluding loans from qualified plans and relocation loans—as compensation to those individuals that is currently includible in gross income, unless the loan is in writing, is adequately secured by collateral other than stock, capital or profits interests in the employer, options, restricted stock or nonqualified deferred compensation, and payable on a fixed schedule not to exceed 10 years;
- Increase the minimum imputed interest rate on below-market loans made after the date of enactment to the applicable Federal rate plus 3%, if the amount of all outstanding loans made to officers, directors, and 5% owners exceeds $1 million; and
- Effective beginning in 2003, increase the withholding rate on supplemental wage payments—such as bonuses and commissions—in excess of $1 million to any employee, in any taxable year, to the highest marginal income tax rate.

NESTEG also contains numerous provisions affecting qualified retirement plans.

ACCAA and NESTEG are just two of the many legislative changes currently being considered in Congress. We are carefully monitoring developments as they relate to employee benefit plans and executive compensation arrangements and urge you to consult us with any questions you may have regarding the implications on your plans and arrangements.

* * *

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