

Employee Benefits Client Alert

SENATE APPROVES LIMITATIONS ON DEFERRED COMPENSATION ARRANGEMENTS

On May 11, 2004, the Senate passed, by a 92-5 vote, S. 1637, the Jumpstart Our Business Strength (JOBS) Act, after adding a late amendment by Senator Grassley adding limitations on deferred compensation arrangements excised from the tax bill of the previous year.

This is the latest chapter in a saga going back to 1977, when, in GCM 36998 (February 9, 1977), the IRS General Counsel put forth a theory of “dominion and control,” under which the Service, backtracking from published rulings going back to Rev. Rul. 60-31, 1960-1 C.B. 174, proposed a regime under which the deferral of future income to be earned by a cash-basis employee would be taxed currently on the deferred income based upon (a) his right to the income, (b) his voluntary decision to defer it, and (c) his “dominion and control over the withheld amount evidenced by his directing or authorizing the employer to invest the sums for his benefit with the accompanying risk remaining on the employee.” The Service then announced, in Internal Revenue News Release IR-1881 (September 1, 1977), that it would no longer issue rulings on nonqualified deferred compensation plans. The issue was fully engaged on February 3, 1978, when the Service issued Prop. Reg. § 1.61-16, 43 Fed. Reg. 4638, under which an employee who, as part of a plan, had exercised an option to defer a portion of his regular compensation, including bonuses, would have the amount deferred taxed to him at the time, it would have been paid to him but for his deferral election.

Congress reacted by including in the Revenue Act of 1978, as Section 132 thereof, a provision mandating that:

The taxable year of an inclusion in gross income of any amount covered by a private deferred compensation plan shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978.

Section 132 effectively imposed a moratorium on any substantive change by the IRS in the rules governing deferred compensation by taxable employers and their employees. (State and local government employers and their employees were governed under a separate regime in Section 457 of the Code, adopted as part of the Revenue Act of 1978, which was extended in 1986 to tax-exempt organizations and their employees.)

The JOBS bill, if enacted with the Grassley amendment, would, by legislative rather than administrative fiat, rewrite the rules relating to constructive receipt. It would impose upon deferred compensation interest from the date the compensation would have received had it not been deferred, plus 10% of that compensation, unless the deferred compensation was subject to a substantial risk of forfeiture or the nonqualified deferred compensation plan (a term that would include individual arrangements) met several requirements. Chief among these is that distributions be made either at a specified time or pursuant to a fixed schedule, or at the death or separation from service of the employee, absent the earlier disability of the employee or the occurrence of an unforeseeable emergency. Consistent with the Service's long-standing ruling position (and, therefore, safe practice), though not with the results of litigation, the initial deferral election would have to be made during the year preceding the year in which the income to be deferred is earned. Any change in the time or form of distribution, *i.e.*, subsequent to the initial deferral election, would require a lapse of 5 years to take effect; 12 months in the case of death, disability, or an unforeseeable emergency or a change in a fixed schedule of payments, on a one-time-only basis.

The plan would also have to provide investment options comparable to those existing under qualified plans of the employer and would require limitations on further elections to defer income. One area specifically targeted is the use of offshore funding, a popular stratagem used in deferral arrangements funded through a rabbi trust, which, under the current IRS ruling position, must be subject to the claims of creditors, something offshore funding frustrates as a practical matter. Another is the transfer of assets restricted to funding a deferred compensation arrangement in connection with a change in the employer's financial health.

These changes, if enacted, would be effective to amounts deferred in taxable years beginning after December 31, 2004.

It should be noted that a slightly shorter version of the Grassley amendment appears in the current version of the American Jobs Creation Act of 2004, introduced in the House on June 4, 2004, as H.R. 4520. This version lacks the S. 1637 requirement of investment options comparable to those existing under qualified plans of the employer and would impose a higher (by one percentage point) rate of interest on income deferred under an arrangement not meeting the requirements of the proposed Code provision, which, as proposed, would generally be effective for amounts deferred after June 3, 2004.

If you have established or contemplate establishing or modifying a deferred compensation arrangement, please communicate with either Laurence Reich (973-565-2003), Warren K. Racusin (973-425-8743), Michael P. Einbinder (973-425-8682), or Alan O. Dixler (973-425-8724).

~ Laurence Reich
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