June 30, 2004

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max S. Baucus
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable William M. Thomas
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways & Means
1106 Longworth House Office Building
Washington, DC 20515

Re: The Effective Date of Nonqualified Deferred Compensation Plan Restrictions

Gentlemen:

I am writing on behalf of the Section of Taxation of the American Bar Association concerning recent proposals considered by Congress in connection with pending tax legislation. The views expressed herein represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Both the American Jobs Creation Act of 2004 (H.R. 4520) and the Jumpstart Our Business Strength Act (S. 1637) would, if enacted, impose new restrictions on nonqualified deferred compensation plans. These restrictions (referred to in this letter as the "new rules") would substantially change the law that has been in effect for many decades. The Section of Taxation is concerned that the effective date provisions of these bills would impose material burdens on a large number of taxpayers, for which adequate time for implementation has not been provided.

1. **A June 3, 2004, effective date for existing plans is almost impossible to implement**

The new provisions would affect all forms of deferred compensation, from automatic arrangements implemented unilaterally by employers to provide supplemental pension income to voluntary arrangements under which employees are permitted to defer salary and/or bonuses. These programs cover active, terminated and retired employees and their beneficiaries. Virtually all of these programs operate on a calendar year basis. Few if any employers have payroll or plan records that would enable them to differentiate between amounts deferred or credited before or after June 3, 2004. In most cases it is unlikely that employee accruals under these programs could be determined on that date, absent a tremendous amount of expense and effort. The only practical solution to a June 3, 2004 effective date may be to modify the program retroactively to December 31, 2003 – but many employers likely will be contractually precluded from making such a retroactive change. (We believe that as a matter of contract, a majority of plans permit prospective amendments only.) Moreover, it is unfair as a matter of tax policy...
to impose such changes on a retroactive basis. This problem is exacerbated by the uncertainty of the legislation’s passage. Systems and administrative changes that would be required to accommodate a June 3 effective date will require a long lead time to implement and substantial expenditures, yet with the uncertainty of passage of the new rules, many companies likely will be reluctant to commit the resources needed to implement the changes. Accordingly, we believe that these provisions should not become effective until a reasonable period has been allowed for revision. We would suggest that January 1, 2006 would be a reasonable date with respect to amounts accrued under an existing plan and attributable to services performed before that date.

We also note that new W-2 reporting is required in respect of deferred compensation and we doubt that either the IRS or employers will be in a position to have new systems in place to accomplish this for the taxable year ending December 31, 2004.

2. Application of the new rules to amounts already credited and elections previously made

a. The grandfather should apply to amounts already credited to employees’ accounts, whether or not vested, and also to deferral elections already in place on the effective date.

Both the House and Senate bills base the application of the effective date rules on the time at which amounts are deferred. Although the legislation does not describe when an amount is "deferred," we believe that the intent of the rule is that if a known amount is credited to a participant's account before the effective date, the amount would be treated as "deferred" before the effective date, whether or not it is vested at that date. For example, if an employee were credited with 100 stock units on February 1, 2003, subject to vesting over each of the following four years, with delivery to occur on January 1, 2009, none of the units would be subject to the new rules. Similarly, if an employee had $10,000 in employer matching contributions credited to his account under a supplemental 401(k) arrangement on the effective date that would vest in 2 more years this amount would be covered by the grandfather. Also, if an employee elected in December 2003 to defer a bonus to be earned during calendar year 2004 and paid in early 2005, that deferral election and any amounts ultimately deferred should be covered by the grandfather. Such an election would have been made consistent with current law, in good faith, and well before the effective date of the new rules. We believe that clarifying language covering these points should included in the legislation.

b. The new rules should not apply to new elections on grandfathered amounts except in clearly specified circumstances.

The House and Senate bills are not clear as to whether a change made with respect to amounts deferred prior to the effective date of the legislation will cause those amounts to become covered by the new rules. The report of the staff of the Joint Committee on Taxation states: "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." Any post-effective date election (or failure to make an election) under an existing plan could be viewed as resulting in amounts being “further deferred” under the plan. We disagree with the desirability of the approach set forth in the quoted language, and believe that amounts deferred in good faith under prior law should not become subject to the new rules by reasons of future elections or other actions that would not adversely affect the deferral under existing law. However, we believe that, regardless of whether or not future changes made to prior deferrals result in the amounts becoming subject to the new rules, this question should be specifically addressed in the legislation itself, rather than being addressed only in legislative history or staff reports.

c. Opportunity to Unwind Arrangements.

If the grandfather provision ultimately does not cover the situations described in (b) and (c) above, we believe that the legislation should specifically provide for a period of at least 12 months during which employers maintaining deferred compensation arrangements are permitted to unwind the arrangements, resulting in current tax to the participants with respect to distributions under the arrangements, but no interest or penalties. Otherwise, it would be unfair as a matter of policy to so drastically change the rules for deferred compensation with respect to the many employers and individual taxpayers who entered into good faith arrangements to defer compensation under current law. In some cases, these arrangements were entered into many years ago. If such taxpayers are not permitted to keep the terms of their existing contractual arrangements, they should be offered the opportunity to exit those arrangements without penalties (other than ordinary income tax, of course).
d. **Elections for periods of service that already have begun.**

The new rules generally would require deferral elections to be made prior to the beginning of the year in which the compensation is earned. However, subject to certain limits, current case law generally would permit elections to be made during the period in which amounts are earned. In reliance on this case law, many employers have structured their non-qualified deferred compensation plans (e.g., an annual bonus plan) to permit deferral elections to be made after the performance period has begun but while the outcome is uncertain. For example, an election might be permitted anytime during the first year of two-year performance period to defer a bonus payable based on the Company’s financial performance during that two-year period. The proposed effective date rule would preclude employers from permitting elective deferrals under arrangements in place for the current year, although such deferrals would be permitted under current law. Because these employers relied in good faith on current law, we believe it would be appropriate to include in the legislation a transition rule, providing that if a deferral election is made no more than 180 days after the enactment of the new law, under a plan that was in place prior to the enactment, with respect to amounts that would be earned for a period ending not later than one year after enactment, that election, and amounts subject to the election, would be subject to prior law.

We appreciate your consideration of these comments. Representatives of the Section would be pleased to discuss them in further detail with you or members of your respective staffs. Please contact Stuart Lewis, the Section’s Vice-Chair for Government Relations, at (202) 452-7933 if that would be helpful.

Sincerely,

Richard A. Shaw
Chair, Section of Taxation

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cc: Hon. John Snow, Secretary of the Treasury
Gregory Jenner, Acting Assistant Secretary of the Treasury (Tax Policy)
George Yin, Chief of Staff, Joint Committee on Taxation
Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
Russ Sullivan, Democratic Staff Director, Senate Finance Committee
Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee