

NEW SENATE FINANCE COMMITTEE PROPOSALS SIGNIFICANTLY CURTAIL DEFERRED COMPENSATION

New York
January 17, 2007

Earlier today, the Senate Finance Committee unanimously approved the Small Business and Work Opportunity Act of 2007, which includes proposals that would:

- significantly curtail any employee's ability to defer compensation in excess of \$1,000,000 per year; and
- apply the Section 162(m) \$1,000,000 deduction limitation to payments made to a "covered employee" even after such individual ceases to serve in that capacity.

While it is impossible to predict whether, or in what form, this legislation will be passed, it should be noted that the proposal had bipartisan support of both Republican and Democratic members of the Senate Finance Committee. In addition, as part of a much publicized bill to raise the Federal minimum wage and assist small businesses, the Chairman of the Senate Finance Committee, Senator Max Baucus, urged his colleagues to "keep their amendments to a minimum" in order to ensure prompt passage of the legislation.

The only description of these proposals can be found in the Joint Committee on Taxation, *Description of the Chairman's Modification of the Provisions of the "Small Business and Work Opportunity Act of 2007"* (JCX-5-07) January 17, 2007, an abridged copy of which is attached hereto.

Annual \$1 Million Cap on Deferred Compensation

The Senate Finance Committee's proposal would significantly curtail deferred compensation by limiting the annual aggregate amount of compensation that can be deferred by an individual under a nonqualified deferred compensation plan to the lesser of (1) \$1,000,000 or (2) the average annualized includible compensation of the employee during the immediately preceding five years.¹ Earnings (whether actual or notional) on

¹ The proposal states that it is intended that annualized includible compensation is to be determined under rules similar to those relating to golden parachute payments under Section 280G of the Internal Revenue Code of 1986, as amended (the "Code").

nonqualified deferred compensation deferred in taxable years beginning after December 31, 2006 would also be subject to the proposed aggregate limitation.

Because of the breadth of the definition of nonqualified deferred compensation in Section 409A of the Code, this proposal could effectively limit a wide variety of deferrals to \$1,000,000 per year in the aggregate (applying plan aggregation rules similar to those under Section 409A), including deferrals under excess plans, SERPs and periodic severance payments. Such a limitation will likely cause employers to pay severance in a lump sum and to provide for the payment of compensation simultaneously with vesting so that it would constitute a short-term deferral and not be considered deferred compensation for purposes of Section 409A.

The proposal is “effective” for “amounts deferred” in taxable years beginning after December 31, 2006. The transition language applicable to Section 409A also made reference to “amounts deferred” and the IRS interpreted that language to grandfather only those amounts with respect to which the employee had a legally binding and vested right as of the effective date. Thus, deferrals of a discretionary 2006 bonus determined in early 2007 or a 2006 bonus that requires continued employment through a payment date in 2007 may not be grandfathered.

Failure to comply with the proposed limit would result in the same consequences as any other failure to comply with Section 409A of the Code.² Thus, even a de minimis excess deferral will result in all of the employee’s deferred compensation under the nonqualified deferred compensation plan and similar plans (applying plan aggregation rules similar to those under Section 409A) being immediately includible in such employee’s gross income and subject to penalties and interest. This result is particularly troublesome in that items such as earnings on deferred compensation, which may be unpredictable, count against the \$1,000,000 limit.

The proposal directs the Treasury to issue guidance which would permit the modification of existing outstanding deferral elections prior to December 31, 2007 in order to comply with the proposed limitation.

² The failure to comply with these requirements would result in all amounts deferred by an individual under the nonqualified deferred compensation plan for all taxable years being currently includible in such individual’s gross income, to the extent not previously included in gross income. In addition, a Section 409A violation would result in the imposition of interest at the underpayment rate plus one percentage point on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when first not subject to a substantial risk of forfeiture, as well as an additional 20% tax on the amount required to be included in income.

Expanded Definition of “Covered Employee” under Section 162(m)

Subject to certain performance-based exceptions, Section 162(m) of the Code generally disallows the deduction of compensation in excess of \$1,000,000 paid by a public company to its “covered employees” for a given taxable year. The current definition of “covered employees” includes the company’s Chief Executive Officer as of the close of the taxable year and its next four highest-paid executive officers as reported in the company’s proxy statement. The proposal would expand this definition to also include (1) any individual who was the Chief Executive Officer of the company at any time during the taxable year and (2) any individual (or his or her beneficiary) who is at any time a covered employee for any taxable year beginning after December 31, 2006.³

As a result, any compensation paid to an individual who, at any time during a taxable year beginning after December 31, 2006, served as the Chief Executive Officer or as one of the next four highest-paid executive officers, will continue to be subject to the \$1,000,000 deduction limitation of Section 162(m), regardless of whether such compensation was paid after such individual ceased to serve in such capacity (including if paid following the termination of such individual’s employment).

Under current law, in order to preserve a deduction under Section 162(m), many employers automatically deferred non-performance based compensation in excess of \$1,000,000 until the covered employee’s termination of employment. This practice will no longer be possible under the new proposal since once an executive becomes a “covered employee” any compensation subsequently received by such employee is subject to the Section 162(m) deduction limitations, including severance. It is also important to note in this context that the proposed change to Section 162(m) is in addition to the change that otherwise limits deferrals as discussed above.

The proposal is effective for taxable years beginning after December 31, 2006. It is not clear, however, how the proposal will apply to amounts deferred prior to January 1, 2007 by a person who is a “covered employee” in 2007 or thereafter. There is no express exclusion under the proposal for compensation deferred prior to January 1, 2007.

In light of this proposal and in light of the fact that for calendar-year taxpayers Section 162(m) requires that performance goals be established for annual plans within the first 90 days of the year, employers should begin to consider now whether to change existing plans in order to comply with the performance-based exception provided for under Section

³ Presumably the definition of “covered employee” will also be conformed to the revised SEC proxy disclosure rules which require disclosure of compensation information relating to the principal executive officer, principal financial officer and the next three highest-paid executive officers.

162(m). Employers should understand that there are certain plans, such as those relating to severance, which are not readily susceptible to being changed to a performance-based plan.

Please call any of your regular contacts at the firm or any of our partners and counsel listed under Employee Benefits in the Our Practice section of our web site (<http://www.clearygottlieb.com>) if you have any questions about these matters.

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**DESCRIPTION OF THE CHAIRMAN'S MODIFICATION
OF THE PROVISIONS OF THE
"SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007"**

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on January 17, 2007

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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F. Limit Amounts of Annual Deferrals Under Nonqualified Deferred Compensation Plans

Present Law

Amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.²⁷ The requirements include rules relating to distributions, acceleration of benefits and funding. For example, distributions from a nonqualified deferred compensation plan may be allowed only upon certain times and events. Rules also apply for the timing of elections. In general, elections to defer compensation for a taxable year must be made not later than the close of the preceding taxable year. Section 409A does not include rules limiting the amount that may be deferred under a nonqualified deferred compensation plan.

A nonqualified deferred compensation plan generally includes any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) and an eligible deferred compensation plan (sec. 457(b)) is a qualified employer plan.

If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Description of Proposal

The proposal adds an additional requirement to the rules governing the income inclusion of amounts deferred under a nonqualified deferred compensation plan. Under the proposal, the annual aggregate amounts deferred under a nonqualified deferred compensation plan by an individual may not exceed the lesser of (1) \$1 million or (2) the individual's annualized includible compensation. If the requirement is not satisfied, the present-law sanctions for failure to satisfy section 409A apply. Thus, if the requirement is not satisfied, all amounts deferred under the nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If the requirements of the proposal are not satisfied, as under present law, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a

²⁷ Code sec. 409A.

20-percent additional tax.²⁸ Aggregation rules apply as necessary to carry out the purposes of the proposal.

Annualized includible compensation is the average annual compensation for services performed for the employer sponsoring the deferred compensation plan (or a predecessor or related entity) that was includible in the individual's gross income for the five-year period preceding the year for which the limitation is being determined.²⁹ In the case in which an election to defer amounts is made, annualized includible compensation is the average annual compensation for services performed for the employer sponsoring the deferred compensation plan (or a predecessor or related entity) that was includible in the individual's gross income for the five-year period preceding the year in which the election to defer is made. The proposal applies to all amounts deferred under nonqualified deferred compensation plans (as defined under section 409A), including plans of both private and publicly-held corporations.

Earnings (whether actual or notional) attributable to nonqualified deferred compensation are treated as additional deferred compensation and are subject to the proposal. Earnings on amounts deferred in taxable years beginning before January 1, 2007, are not subject to the proposal. Future earnings (actual or notional) on amounts included in income under the proposal are includible in income as earned.

The proposal is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the proposal. The proposal does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The proposal provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the purposes of proposal.

Effective Date

The proposal is effective for amounts deferred in taxable years beginning after December 31, 2006. The proposal directs Treasury to issue guidance allowing existing outstanding deferral elections to be modified on or before December 31, 2007, in order to reduce deferrals for taxable years beginning after December 31, 2006, to the extent needed to comply with the proposal, without violating the requirements of section 409A.

²⁸ These consequences apply under the provision to amounts deferred after the effective date of the provision.

²⁹ It is intended that annualized includible compensation is determined under rules similar to the rules relating to golden parachute payments (sec. 280G) except that no change in ownership or control is required.

N. Modify Definition of Covered Employee for Denial of Deduction for Excessive Employee Remuneration

Present Law

Under present law, compensation in excess of \$1 million paid by a publicly-held corporation to the corporation's "covered employees" generally is not deductible.⁵¹ Covered employees are the chief executive officer as of the close of the taxable year and the four other most highly compensated officers of the company as reported in the company's proxy statement.

Subject to certain exceptions, the deduction limitation applies to all otherwise deductible compensation of a covered employee for a taxable year, regardless of the form in which the compensation is paid, whether the compensation is for services as a covered employee, and regardless of when the compensation was earned. The deduction limitation applies when the deduction would otherwise be taken.

Performance-based compensation is not subject to the deduction limitation and is not taken into account in determining whether other compensation exceeds \$1 million. In general, performance-based compensation is compensation payable solely on account of the attainment of one or more performance goals and with respect to which certain requirements are satisfied, including a shareholder approval requirement.⁵²

Description of Proposal

The proposal modifies the definition of covered employee. Under the proposal, covered employees include any individual who was the Chief Executive Officer of the company at any time during the taxable year. In addition, covered employees include the four officers with the highest compensation for the year. Under the proposal, covered employees also include individuals who previously were covered employees for any preceding taxable year beginning after December 31, 2006, with respect to the corporation (and beneficiaries of such persons). For example, if the Chief Executive Officer retires in November, compensation received in the year of retirement, or paid under a deferral agreement in a succeeding year, is subject to the deduction limitations for a covered employee.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2006.

⁵¹ Sec. 162(m).

⁵² In addition, the following types of compensation are not subject to the deduction limitation and are not taken into account in determining whether other compensation exceeds \$1 million: (1) compensation payable on a commission basis; (2) payments to a tax-qualified retirement plan (including salary reduction contributions); and (3) amounts that are excludable from the individual's gross income (such as employer-provided health benefits). Sec. 162(m)(4).