

SENATE FINANCE COMMITTEE PUBLISHES LEGISLATIVE TEXT OF DEFERRED COMPENSATION PROPOSALS

New York
January 22, 2007

Earlier today, the Senate Finance Committee (the “Committee”) published the legislative text of the Small Business and Work Opportunity Act of 2007 (the “Act”), which includes amendments to the Internal Revenue Code of 1986, as amended (the “Code”), that would, if enacted:

- significantly curtail any employee’s ability to defer compensation in excess of \$1,000,000 per year under Section 409A of the Code¹; and
- broaden the definition of “covered employee” under Section 162(m) so as to apply the \$1,000,000 deduction limitation to payments made to a “covered employee” even after such individual ceases to serve in that capacity.

The Committee also published the *Finance Committee Report to the “Small Business and Work Opportunity Act of 2007,”* dated January 22, 2007 (the “SFC Report”). Copies of the relevant sections of the legislative text and the SFC Report are attached hereto.

The legislative text generally reflects the description of the proposals provided 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 (the “Chairman’s Markup”). However, in certain instances, the legislative text and the SFC Report help to clarify ambiguities contained in the Chairman’s Markup.

The following memorandum is intended to highlight some of the key clarifications provided by the legislative text and the accompanying SFC Report. For a more comprehensive discussion of the Committee’s proposals, as set forth in the Chairman’s Markup, please see our Alert Memorandum entitled *New Senate Finance Committee Proposals Significantly Curtail Deferred Compensation*, dated January 17, 2007.

¹ Unless otherwise noted, all section references herein are to the Code.

Section 206 of the Act: Annual \$1 Million Cap on Deferred Compensation

Section 206 of the Act would significantly curtail deferred compensation by amending Section 409A to limit 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, calculated for the relevant base period as described below.

Certain ambiguities in the the Chairman’s Markup have been addressed through today’s publication of the legislative text of Section 206 of the Act, though others remain. The following is a general overview of some of the clarifications provided by the legislative text and the SFC Report.

- **Plan Aggregation:** All nonqualified deferred compensation plans maintained by all employers treated as a single employer are treated for purposes of Section 206 as one plan. This plan aggregation rule is significantly more stringent than the general Section 409A plan aggregation rule, which provides for separate categories of nonqualified deferred compensation plans for purposes of general Section 409A compliance. Therefore, amounts deferred under such disparate plans as a restricted stock unit plan and an excess pension plan would need to be aggregated for purposes of the annual deferral limitation. It is not clear from the text of the legislation or the SFC Report whether, in the event of a violation of the annual deferral limitation, the general Section 409A plan aggregation rules, on the one hand, or the proposed plan aggregation rule under Section 206 of the Act, on the other hand, would apply in determining what amounts would be includible in an individual’s gross income.
- **Earnings:**
 - *Current Earnings as Additional Deferred Compensation:* Though the legislative text is not entirely clear, the SFC Report clearly states that earnings (whether actual or notional) attributable to nonqualified deferred compensation are treated as additional deferred compensation for purposes of calculating the aggregate amount of compensation deferred with respect to a given taxable year. It is not clear how grandfather rules under Section 206 of the Act would apply to earnings on amounts deferred prior to December 31, 2006.
 - *Inclusion of Future Earnings:* If a participant is required to recognize any deferred compensation amounts in gross income for a taxable year by reason of his or her failure to comply with the proposed legislation, then such participant will also be required to recognize

any earnings (whether actual or notional) attributable to such deferred compensation (or income attributable thereto) for any subsequent taxable year, to the extent such earnings are not subject to a substantial risk of forfeiture and have not been previously included in gross income. The present-law sanctions under Section 409A (interest at the underpayment rate plus 1% and a 20% additional tax) would also apply.

- **Calculation of Average Annual Compensation:**

- *Calculation of Base Period:* The legislative text makes clear that for purposes of calculating an individual's average annual compensation, the base period is the five-taxable-year period ending with the taxable year preceding the taxable year for which the limitation is being determined (the "Computation Year"); provided that if, before the beginning of the Computation Year, a participant elects to defer compensation to be earned for the Computation Year, the base period is the five-taxable-year period ending with the taxable year preceding the taxable year in which the election is made.² Thus, for example, if a participant elected in 2008 to defer compensation to be earned in 2009, the base period for purposes of calculating such participant's average annual compensation with respect to the 2009 Computation Year, would run from 2003 to 2007.³
- *Employee with Less than Five Years of Service:* The legislative text also clarifies that, with respect an employee who has performed services for the employer for less than five years, only the period for which such employee performed services will be taken into account in calculating such employee's average annual compensation.

- **Plan Compliance:** The legislative text states that the new annual deferral limitation will be met if the plan provides that the aggregate amount of compensation deferred for any taxable year with respect to a participant under the plan may not exceed the applicable dollar amount for such taxable year.

² Neither the proposed legislative text nor the SFC Report is clear in how to calculate the base period for an individual participating in both elective and mandatory nonqualified deferred compensation plans.

³ Though it is not clear from the legislative text, it appears that an election to defer compensation earned in any future year may fix the five-taxable-year period for computing an individual's average annual income. For example, if a participant elects in 2008 to defer compensation to be earned pursuant to a long-term performance incentive plan in 2012, the five-taxable-year period may be the period from 2003 to 2007.

Accordingly, the legislative text appears to require that all nonqualified deferred compensation plans be amended to reflect the new limitation.

- **Effective Date:** The amendments would apply to taxable years beginning after December 31, 2006, except that:
 - the amendments would only apply to amounts deferred after December 31, 2006 (and earnings on such amounts); and
 - taxable years beginning on or before December 31, 2006 would be taken into account for purposes of calculating an individual's average annual compensation.

- **Guidance Relating to Certain Existing Arrangements:** Within 60 days of enactment, the Secretary of the Treasury is required to issue guidance providing a limited transition period during which a nonqualified deferred compensation plan adopted before December 31, 2006 may be amended:
 - to provide that a participant may, no later than December 31, 2007, cancel or modify outstanding deferral elections relating to amounts to be deferred after December 31, 2006, to the extent necessary to comply with the requirements of Section 206 of the Act, *but* only to the extent such amounts are includible in income of the participant when no longer subject to substantial risk of forfeiture; and
 - to conform to the requirements of Section 206 of the Act with regard to amounts deferred after December 31, 2006.

Section 214 of the Act: Expanded Section 162(m) Definition of “Covered Employee”

Section 214 of the Act would expand the definition of “covered employee” under Section 162(m) to include (1) any individual who was the chief executive officer of the company at any time during the taxable year (and not just, as under the current rule, the chief executive officer at the end of 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. 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 compensated 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 or such individual's death).

The legislative text of Section 214 of the Act does little to clarify the ambiguities identified in our January 17th Alert Memorandum. The legislative text and the SFC Report do, however, contain a clear acknowledgment that the definition of the term “covered employee” is not linked to the definition of the term “named executive officer” under the new SEC proxy disclosure rules. Among the issues that appear to be raised by the delinking of these definitions are (i) whether foreign private issuers might become subject to Section 162(m) and (ii) how to determine who is an “officer” and which officers are the “highest compensated” for purposes of Section 162(m).

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