GROOM LAW GROUP

January 19, 2007

MEMORANDUM TO CLIENTS

RE: <u>The Senate Finance Committee Takes Aim at Executive Compensation – Again</u>

On January 17, 2007, the Senate Finance Committee unanimously passed the Small Business and Work Opportunity Act of 2007 (the "Act") containing two provisions that could significantly change the tax treatment of executive compensation arrangements. The Act will accompany the legislation increasing the minimum wage that will be voted on in the Senate and contains a number of provisions aimed at tax relief for small businesses. The executive compensation provisions are part of the revenue raisers that will be used to offset the costs of the small business tax relief.

The provisions aimed at executive compensation will further expand the reach of section 409A of the Internal Revenue Code (the "Code") and toughen the Code section 162(m) deduction limits. The change to section 409A apparently would limit the following types of deferrals to an individual's average annual taxable compensation (or $1 million per year, if less).

- employee and employer contributions to classic deferred compensation plans made after 2006
- earnings on such contributions made after 2006
- accruals under supplemental retirement plans ("SERPS") and "mirror" 401(k) plans
- amounts payable under certain equity compensation awards, such as restricted stock units
- amounts payable under certain executive severance arrangements

If these provisions are enacted in their current form, many companies would need to make major changes to their executive compensation practices for affected employees to avoid substantial tax penalties.

<u>Changes to Section 409A</u>

<u>Current Rules</u>. Section 409A was added to the Code by the American Jobs Creation Act of 2004 and imposes new restrictions on deferral elections and distributions under nonqualified deferred compensation plans. In addition to classic deferred comp arrangements, section 409A applies to SERPS, "mirror" 401(k) plans, certain equity compensation arrangements, and certain executive severance arrangements. If the section 409A requirements are not satisfied, all vested

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amounts under a nonqualified deferred compensation plan are immediately includible in income – i.e., the favorable tax effect of the deferral is lost. In addition, the amount included in income will be subject to a 20 percent additional tax and interest.

Limitation on Deferrals. The current section 409A rules do not limit the amount that may be deferred under plans subject to section 409A. The bill passed by the Senate Finance Committee would revise section 409A to limit an individual's annual deferrals under such plans to the lesser of (1) $1 million, or (2) the five-year average of the individual's annual taxable compensation. Thus, the proposal is similar to imposing a section 415-type limit on nonqualified deferred compensation. If an individual's annual deferrals exceed the limit, all of the individual's deferred compensation will be immediately taxable and subject to the additional 20 percent tax and interest under section 409A. It appears that not only amounts that are subject to section 409A would be subject to immediate taxation, but amounts that were grandfathered from Code section 409A (generally amounts vested at the end of 2004) could be taxed immediately too.

This $1 million annual limit would apply beginning in 2007. However, the bill would permit modification of outstanding elections during 2007 to the extent necessary to comply with the new rule.

Aggregation of Plans. Different types of deferred compensation plans may need to be aggregated for purposes of determining (1) whether the $1 million annual deferral limit has been exceeded, and (2) the amounts subject to adverse treatment under section 409A if the limit is exceeded. The IRS will have to develop rules regarding plan aggregation for these purposes. Current rules under section 409A provide that all plans within a particular category must be aggregated for purposes of determining the amounts subject to adverse tax treatment. Those categories are: account balance plans, nonaccount balance plans, severance plans and equity-based compensation plans.

Calculating the Annual Deferral Amount. The bill generally does not address how the annual amount of deferrals under various arrangements will be calculated for this purpose. Questions will arise in particular with SERPS, where the amount of the benefit often increases or decreases depending on the amount of the benefit in a related tax-qualified plan. The bill provides that earnings are considered deferrals for this purpose, other than earnings on amounts deferred before 2007. Currently not addressed in the legislation is how to determine the amount of earnings under various arrangement for this purpose or how negative earnings (which occur when earnings track actual investment portfolios) will affect the limit.

Application of the Limitation. This provision is far-reaching. It will apply to all companies, regardless of whether they are publicly or privately held. It also applies to all individuals providing services; it is not limited to employees. Since annual deferrals are limited to the average of taxable compensation over the last five years, benefits of lower paid employees may be implicated. A potential trap for the unwary also exists where a high earning executive has deferred a substantial amount of earnings over the last five years, leaving him with average taxable compensation under $1 million.

Because of the reach of this new provision, it will be important to determine whether a plan is a deferred compensation plan subject to section 409A. In general, any plan which provides for payment in a later year of compensation to which an individual has a legally binding right could be a deferred compensation plan subject to section 409A. Statutory exceptions include qualified retirement plans and bona fide vacation, sick leave, compensatory time, disability pay and death benefit plans. The IRS has provided further exemptions from section 409A that include amounts which are payable within 2½ months after the end of the year in which the amounts were vested (the "short term deferral rule") and stock options and stock appreciation rights that were granted with an exercise price at least equal to the fair market value of the stock at date of grant. Grants of restricted stock are also not considered nonqualified deferred compensation.

The new limit could apply to the following types of compensation arrangements:

- Account balance deferred compensation arrangements. Traditional arrangements where an executive agrees to defer all or a portion of salary or bonus, including 401(k) excess and 401(k) mirror plans, would be covered by this new limitation.

- SERPs and other nonelective retirement plans.

- Restricted stock units ("RSUs"). Large grants of RSUs could run afoul of this annual deferral limit since the annual deferral amount attributable to the RSUs would be determined at the grant date, rather than at the time they vest.

- Executive Severance Plans. Certain severance plans may be subject to section 409A, particularly those which provide benefits in excess of two times the employee's annual compensation or, if less, two times the maximum amount of compensation that can be taken into account under a tax-qualified plan ($225,000 in 2007).

Changes to Section 162(m)

Background. In general, section 162(m) caps at $1 million the annual amount of compensation paid to a "covered employee" that a publicly-held corporation can deduct. IRS guidance under section 162(m) provides that a covered employee includes a corporation's chief executive officer ("CEO") and the four other most highly compensated officers as reported in the corporation's proxy statement. Such an individual will not, however, be considered a covered employee for a year unless he is employed by the corporation on the last day of the year.

Expanded Definition of Covered Employee. Effective January 1, 2007, the bill would expand the definition of "covered employee" to include (1) any individual who was the CEO of a corporation at any time during the year, and (2) the four officers with the highest compensation for the year. Essentially, the bill would eliminate the requirement that an individual be employed on the last day of the year to be a covered employee. Perhaps more importantly, the bill would provide that any individual treated as a covered employee at any time after 2006 will be considered a covered employee in all later years, as will his beneficiaries.

Effect on Publicly-Held Companies. By expanding the definition of "covered employee" to include officers after they terminate employment, the bill would subject nonqualified retirement payments, severance payments and other post-termination benefits and perquisites to the annual $1 million deduction limit under section 162(m). Unlike when section 162(m) was enacted, there does not appear to be an exception to this new provision for amounts which are paid under a binding contract entered into before 2007. Consequently, companies may have a legal obligation to make payments and provide benefits to an executive that may not be deductible.

Prospects for Passage

Democrats in the House of Representatives want to pass a bill increasing the minimum wage without including small business tax cuts. But Senate Democrats know that they cannot pass such a bill in the Senate without those tax cuts. Indications are that the President would veto a minimum wage bill without the small business tax cuts. So there will be lots of political and procedural posturing in order to get this minimum wage bill passed.

Even if the executive compensation provisions are stripped from the minimum wage bill, they are now "in play" and could be included in other tax bills moving forward. Since the new budget rules adopted by the House and Senate require that any tax bill be revenue neutral, the passage of tax cuts generally will require additional revenue. In particular, one major priority of the House Democrats is fixing the alternative minimum tax on individuals. One source of revenue could be these executive compensation provisions, which have been scored by the Joint Committee on Taxation as raising approximately $900 million over the 10-year budget period. In short, there will be other opportunities for these provisions – which appear to have bi-partisan support at this time– to be enacted into law this year even if they are not in the final minimum wage bill. That is exactly what happened with the deferred compensation provisions that were ultimately enacted in 2004 as section 409A.