Statement for the Record
Committee on Ways and Means

March 14, 2007

The American Benefits Council submits this statement in connection with the hearing of the House Committee on Ways and Means on the Small Business and Work Opportunity Act of 2007 (the "Act"). We respectfully request that this statement be included in the record of the hearing.

Our comments address two revenue raising provisions included in the Act : (i) Section 226, which expands Internal Revenue Code section 409A to impose dollar caps on nonqualified deferred compensation plans, including all earnings under those plans, equal to the lesser of "one times pay" or $1 million; and (ii) Section 234, which expands Internal Revenue Code section 162(m) to deny employer deductions for certain compensation payments to both current and former top executives of publicly-held companies, including payments that are already scheduled to be made under legally binding contracts.

The American Benefits Council is a public policy organization representing more than 250 members that are primarily major U.S. businesses providing employee benefits to active and retired workers. The Council's members do business in most, if not all, of the states. The Council's membership also includes organizations that provide employee benefit services to employers of all sizes. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The Council's members have raised significant concerns about both the policy and practical effects of sections 226 and 234 in the Act. We believe that both of these revenue raising provisions are significantly flawed and we urge that they be rejected.

Section 226 – Dollar Caps on Nonqualified Deferred Compensation

Section 226 would amend Code section 409A to impose a dollar cap on nonqualified deferred compensation that is the lesser of $1 million or "one times pay" for an employee. The penalty for exceeding this dollar cap is immediate income inclusion of the total nonqualified deferred compensation earned by the employee plus a 20-percent addition to tax and interest. The Council has serious concerns with this

provision because it would impose arbitrary limits on deferred compensation plans and impose draconian tax penalties if those limits are exceeded. The dollar cap is not limited to the pay packages of senior executives. If enacted, the dollar cap in Section 226 would apply to any arrangement that falls within the technical definition of a "nonqualified deferred compensation plan" under Code section 409A. These include non-elective plans, such as retirement-type and supplemental pension plans, incentive compensation, and certain equity arrangements, such as restricted stock units and stock appreciation rights that do not squarely fit within the current regulatory exceptions under section 409A.

Although section 226 of the Act may have been viewed as addressing perceived problems with "executive" pay, the broad spectrum of plans that would be subjected to the dollar cap lead us to conclude that middle management employees likely would see the most drastic changes in their benefit programs should section 226 be enacted. The uncertainties and administrative burdens created by a dollar cap may discourage some employers from providing such programs for middle-management, many of which are designed to complement the employer's tax-qualified retirement plans by allowing employees to save for retirement on their total compensation. We have attached to our statement a number of examples taken from companies, which illustrate the scope of the dollar cap.

Moreover, the effect of the dollar cap included in section 226 of the Act would be to subject nonqualified plan dollars to income inclusion and a potential 20-percent addition to tax before funds are actually paid or made available to an employee. This is a fundamental and, in our view, unwise shift in basic tax principles. Contrary to some erroneous news reports, nonqualified plans are not "funded" or secured like qualified retirement plans. Employees are not guaranteed to receive the money in the event of the employer's insolvency, for example. If such were the case, these amounts would already be subject to income tax under current law. Rather, section 226 of the Act would tax employees before they are actually paid on funds that are "at risk" and on amounts that might never be paid or that might end up being lower in value when they are ultimately paid.

Our members also question why the U. S. income tax system would favor current cash payments in lieu of deferred payments to employees. Employers may have legitimate cash-flow and long term business goals for designing compensation programs that defer payments into the future rather than providing for current cash. Consider, for example, the start-up company that instead of paying higher current salaries promises bonuses or incentive compensation in the future based on the growth and success of the business. At the time that the bonus is promised, it may be worth a relatively small amount. But, if as hoped, the business succeeds, the increased value of that bonus, (i.e., the "earnings") could easily exceed the "one times pay" or the $1 million limit in any future year. Section 226 of the Act would preclude such an arrangement.

There are also troubling technical aspects of section 226 of the Act that would make it difficult to administer and, therefore, easy to inadvertently violate when applied in the real world. As the attached examples illustrate, the "one times pay" prong of the dollar cap and the inclusion of "earnings" in the annual deferrals subject to the cap are both particularly pernicious. Section 223 of the Act would impose the Code section 409A tax penalty on earnings in excess of the applicable dollar limit -- even if the earnings are based on the growth of the business or another market rate of return – which cannot be predicted with certainty.

Our members are also mindful that it just a little over two years ago that Congress enacted the current-law section 409A provisions to regulate deferral elections and the timing of payouts for deferred compensation. These new rules have required sweeping changes in the design of deferred compensation plans and have generated literally hundreds of pages in interim regulatory guidance. Employers have already made significant changes to deferred compensation plans to conform to these complicated new rules and are still awaiting final regulations. Adding arbitrary dollar limits to the 409A rules on the cusp of the publication of final regulations will create excessive regulatory burdens. The massive employer effort required to conform to 409A and modify the design of nonqualified plans since 2005 will, in many cases, have been futile if a dollar cap is now imposed. Design decisions, administrative programs, and legal analyses for nonqualified plans all would have to be revisited in light of the dollar caps.

Finally, experience shows that imposing dollar limits under the Internal Revenue Code skews behavior. Sections 162(m) and 280G, two provisions that impose tax penalties for exceeding compensation dollar limits, have been uniformly criticized as causing greater harm than benefit. Our members are concerned that imposing dollar limits under 409A will inevitably lead to the same result – excessive complexity and arbitrary "winners" and "losers." Employers should be designing compensation systems to further their business goals rather than avoiding disincentives created by the Internal Revenue Code.

Section 234 – Expansion of Code section 162(m)

Section 234 of the Act would expand the definition of "covered employee" as defined under section 162(m) to include anyone who was ever a covered employee or anyone who served as CEO at any point during the year. The expansion of section 162(m) would expand further a provision that experts unequivocally agree is "broken." The staff of the Joint Committee on Taxation (JCT) recommended in 2003 that section 162(m) be repealed altogether. The recommendation was based on the JCT staff's conclusion that the provision is "ineffective at accomplishing its purpose [and] overrides normal tax principles." The JCT staff also noted that "[t]he concerns reflected

in the limitation can better be addressed through laws other than the Federal tax laws." To that end, the Securities and Exchange Commission has promulgated expansive new proxy disclosure rules on executive compensation. Those provisions should be given time to work rather than embark on an attempt to once again use the tax laws to address perceived corporate governance problems.

Our members are also concerned that the section 162(m) proposal applies retroactively to amounts earned before 2007 and payments to which the employer is already contractually obligated. The lack of a binding contract exception is punitive. When Congress enacted the section 162(m) deduction limit in 1993, an exception was included for payments made under existing binding contracts that were not materially modified. We urge that Congress not retroactively change the tax laws with respect to binding compensation arrangements.

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Examples

Restricted Stock Units. In recent years, many employers have redesigned their equity programs to increasingly rely on the use of restricted stock units (RSUs). Typically, employees are awarded a specified number of RSUs, with a fixed percentage of the RSUs vesting on a quarterly or annual basis or the entire block of RSUs vesting after a specified performance period. Generally, upon vesting of an RSU award, RSUs are converted into shares of the employer's common stock and the employee is taxable on the fair market value of such stock. Some RSU programs fit within the regulatory exception from 409A for compensation that is paid upon vesting (or within 2-1/2 months after the year of vesting.) It is not uncommon, however, for employers to find that their RSU program does not meet the short-term deferral exception and that compensation paid under the program is subject to 409A. In some instances, an employee may vest in the RSUs in increments over the performance period but is not paid until full vesting is attained at the end of the performance period. In other instances, an employee may vest fully upon reaching a specified retirement age during the performance period. Under the legislation, such RSU grants would be subject to the "one times pay" limit and could cause employees to exceed the limit.

For example, a newly hired employee of a Fortune 500 company receives a grant of RSUs that is subject to 409A. The employee is granted 6,000 RSUs at a time when the value of the company's stock is $30 (i.e., value of the grant is $180,000). The employee is scheduled to vest in 1/5 of the RSUs each year over a 5-year performance period. The employee receives a base salary of $140,000, which under the Senate provision would be the employee's "one times pay" limit for the first year. Because the value of the RSU grant exceeds the "one times pay" limit, a 409A violation would occur and the employee would be subject to a 20% additional tax on the value of the RSUs as they vest (i.e., 20% of the RSUs per year) over the 5-year period.

Because "earnings" on the underlying shares of the company's stock also are subject to the limit, employees could have a tax penalty under 409A merely because the company was successful and the value of the RSUs increased beyond the limit.

For example, an employee is granted 1,000 RSUs at the beginning of employment with technology company. The employee "vests" in these units after 5 years of service and the RSUs are designed to pay out after 10 years. The employer believes that this plan aligns the employee's interest with growing the company value rather than maximizing current salary. At the beginning of employment, the RSUs were valued at $15 per share. The employee earns approximately $100,000 per year and receives modest increases (based on CPI of 3 percent). The employee's 5-year average taxable compensation from the company is $110,000 at the end of year 5. The company stock price stays relatively flat, but in year 6 the company becomes highly successful and the valuation of the stock takes off eventually to exceed 10 times the original price. The

one-times-pay limit would be exceeded because the increase in the RSU value in year 6 will exceed $110,000.

Supplemental 401(k) Plans. Employees who cannot fully defer under a 401(k) plan because of the compensation limits under the Code may participate in a supplemental or "mirror" 401(k) plan. Unlike qualified plans, these programs are unfunded and the employer's deduction is delayed until the time of payment. If the company becomes insolvent, the employees are not paid. The legislation counts "earnings" that accrue under the supplemental plan as additional deferrals that count against the "one times pay" limit and could cause the employee to exceed the limit.

For example, a Fortune 500 company offers a nonqualified supplemental plan to certain employees, including mid-level management employees receiving approximately $150,000 to $200,000 per year in total wages from the company. Many of these mid-level management employees are long-serving employees who typically defer 20 to 40 percent of their wages. Employees who participate in the plan receive a small matching contribution (typically between $3,000 and $6,000) from the company based on their deferrals. Investment earnings are credited to an employee's bookkeeping account in the plan based upon deemed investments chosen by the employee from among the same mutual funds as those offered in the company's 401(k) plan. Using 2006 data, the company has calculated that at least seven such employees would have exceeded their 5-year average taxable compensation. Below is a chart summarizing the relevant information.

Emp.	Years of Service	2006 Total Wages	5-year Average Taxable Wages	Account Balance As of 12/29/06	2006 Deferrals And Match	2006 Investment Earnings	Total Deferrals	Deferrals Above 5-year Avg Limit
1	27	$ 159,500	$ 90,180	$ 418,400	$ 66,700	$ 72,300	$ 139,000	$ 48,820
2	13	$ 175,400	$ 102,220	$ 508,300	$ 60,800	$ 52,500	$ 113,300	$ 11,080
3	28	$ 179,300	$ 62,380	$ 364,100	$ 116,400	$ 27,000	$ 143,400	$ 81,020
4	25	$ 178,300	$ 126,920	$ 614,700	$ 47,900	$ 109,100	$ 157,000	$ 30,080
5	30	$ 183,700	$ 126,040	$ 617,700	$ 38,000	$ 141,800	$ 179,800	$ 53,760
6	14	$ 194,400	$ 128,020	$ 486,500	$ 62,200	$ 73,200	$ 135,400	$ 7,380
7	6	$ 203,000	$ 92,020	$ 647,100	$ 76,300	$ 94,700	$ 171,000	$ 78,980

Two of these employees (5 and 7) would have exceeded their 5-year average taxable compensation based solely upon their 2006 earnings. Since earnings that are tied to a publicly-traded investment are often very unpredictable, any employee participating in a supplemental 401(k) plan would have to leave a large cushion below the "one times pay" limit to take into account potential earnings. Moreover, a long-serving employee could exceed the annual deferral limit based upon earnings even if the employee stopped making deferral elections.

For example, assume employee 5 in the above example stopped making deferral elections after 2006, and that the employee receives modest increases in wages each year (based on CPI of 3 percent). Also assume that the employee elected to have all of his account balance as of December 29, 2006 ($617,700) be deemed invested in the plan's S&P 500 index fund, and that for the 4-year period from 2007 to 2010 that fund's annual return was 20% per year (which would be consistent with the S&P 500's performance in the late 1990s). By 2010, there would be a 409A violation solely because the earnings credited to the employee's bookkeeping account ($213,477) exceeded the employee's 5-year average taxable compensation from the company ($189,376).

Non-elective, Supplemental Pension Plans. Some companies maintain non-elective, supplemental pension programs to serve as retention tools and assist management employees in saving for retirement. Unlike qualified plans, these programs are unfunded and any employer deduction is delayed until the time of payment. If the company becomes insolvent, the employees are not paid. The nature of many of these plans is to provide the most valuable accruals in the years right before retirement (e.g., age 65) and, therefore, they incentivize employees to stay in their jobs. The legislation would require employers to severely limit or abandon these arrangements because later-year accruals may exceed the "one times pay" limit under common plan designs for long-service employees. The problem would be further exacerbated if the employer wanted to manage its employee headcount by offering an early retirement incentive in the qualified and supplemental pension plans (such as payment of the full pension without a reduction for early commencement). The increased value of the pension in the year that the early retirement incentive was offered could cause the "one times pay" limit to be exceeded.

For example, one Fortune 500 company sponsors a non-elective, supplemental pension plan that is available to middle managers making a little over $100,000 per year, many of which work for the company's retail entity. The company noted the difficulty in calculating annual accruals for this type of plan and the fact that the value of annual accruals often varies significantly from year to year due to interest rate changes and eligibility for early retirement. To the extent an accrual under the supplemental pension plan exceeded the limit, it is not clear how the company could "fix" the pension plan formula to avoid an excess accrual. The company also noted that the impact of the "one times pay" limit would be even more severe because other forms of compensation provided to these managers, such as RSUs, performance units and severance pay, would also be aggregated with accruals under the supplemental pension plan in applying the limit. As a result, the company advised us that they may discontinue the supplemental pension plan if the annual limit is enacted.

Bonuses and Incentive Programs. Many employers structure their bonus programs to fit within the regulatory exception from 409A for compensation that is paid upon vesting (or 2-1/2 months after the year of vesting.) It is not uncommon, however, for

employers to find that they cannot meet this strict 2-1/2 month rule. Employees may vest at the end of the year or at the end of the performance period, but business issues may necessitate a delay in payment that results in the payment being subject to 409A. Some employers may need to wait longer for performance criteria to be ascertained, financials certified, etc., resulting in the payment being subject to 409A and the "one times pay" limit. In other instances, an employee may vest in increments over the performance period or upon reaching retirement age but is not paid until the end of the period, which also would result in the payment being subject to 409A and the "one times pay" limit.

Private Equity. Many private companies (including start-ups) cannot readily conform to the specific administrative rules provided under the 409A regulatory exceptions for equity grants (*e.g.*, stock options and stock appreciation rights) because there is no public market to ensure a true fair market value price for the grant. As a result, many private companies' equity grants are subject to 409A. Under the Senate bill, private companies could not provide this type of equity grant to employees unless the grant does not exceed the one times pay limit. Because "earnings" on the equity also are subject to the proposed limit, employees could have a tax penalty under 409A merely because the company was successful and the value of the equity increased beyond the limit.

Cash Flow and Start Ups. Small and emerging businesses may pay modest current compensation during the early stages of the business but promise significant future compensation, including retirement payments, in order to attract and retain talented employees. The Senate bill limits the business from making any promise that exceeds "one times pay" for employees.