Reject Dollar Caps on Deferred Compensation

A revenue raiser in the Senate-passed version of H.R. 2 would impose dollar caps on nonqualified deferred compensation plans. The Senate revenue raiser would expand Internal Revenue Code section 409A to limit deferrals, including all earnings, to the lesser of $1 million or "one times pay" annually. This revenue raiser is significantly flawed and should be rejected.

The tax laws should not favor current cash over deferred compensation. Employers 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. The dollar cap puts arbitrary limits on deferred compensation, including incentive compensation and retirement-type programs.

- 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. There is no sound reason for the tax laws to impose a dollar limit on those future payments, which is the result under the Senate-passed provision.

- Including "earnings" in the annual deferral limit is particularly pernicious. As the above example illustrates, the Senate-passed provision would impose the 409A tax penalty on earnings in excess of the 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.

The dollar cap would hit middle managers and erode retirement savings. Although the provisions have been described as addressing perceived problems with "executive" pay, middle management employees likely would see the most drastic changes in their benefit programs. The uncertainties and administrative burdens created by a dollar cap may discourage some employers from providing such programs for middle-management, which are designed to complement the employer's tax-qualified retirement plans by allowing employees to save for retirement on their total compensation.

The system should not impose tax on individuals where funds are at risk. There is no sound tax rationale for subjecting nonqualified plan dollars to income inclusion before the funds are actually paid or for imposing a tax penalty on these dollars, both of which result under the Senate-passed bill.

- 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.

- Taxing employees before they are actually paid on funds that are "at risk" is fundamentally unfair, which is the result under the Senate-passed provision if a nonqualified plan exceeded the dollar caps.

The Congress has already addressed election and payout rules for deferred compensation under 409A and employers are still awaiting final rules. Congress enacted the current-law section 409A provisions to regulate deferral elections and the timing of payouts for deferred compensation beginning in 2005. 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. Design decisions, administrative programs, and legal analyses for nonqualified plans will have to be revisited in light of the dollar caps.

Dollar caps in the tax laws create arbitrary results. 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. 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.