



APPLICATION OF SENATE DEFERRAL LIMIT TO EARNINGS

- Counting “earnings” as an annual deferral subject to the deferral cap could cause a 409A violation – and the application of onerous tax penalties of 50 to 60 percent -- where the earnings are based on the growth of the business or another market rate of return, which cannot be predicted with any certainty.
- In the case of “earnings” based upon the underlying shares of a company’s stock or otherwise tied to the performance of the business, an employee could be subject to the onerous tax penalties under section 409A simply because the company was *successful*.
 - Many employers have redesigned their compensation programs to increasingly rely on the use of restricted stock units (RSUs) and other types of long-term incentive plans intended to tie employee compensation to the performance of the company. In the case of RSUs, employees typically 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 or upon attainment of retirement age. 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. In some cases, compensation paid under RSU and other long-term incentive plans is subject to section 409A. Because “earnings” based upon increases in the underlying shares of the company’s stock are subject to the limit, employees could incur onerous tax penalties under 409A merely because the value of the RSUs increased beyond the limit.
 - Many start-up businesses cannot pay high current salaries or offer stock options or stock appreciation rights that are exempt from section 409A. Instead, start-up businesses typically promise 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 the business *succeeds*, the increased value of the promised incentive compensation could easily exceed even a \$1 million limit in a 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 dramatically increases the uncertainties and administrative burdens created by the dollar cap on annual deferrals, which in turn makes it more likely that inadvertent violations will occur. Employers would be forced to track, calculate, and aggregate the annual amount of deferrals and earnings in the various types of arrangements subject to section 409A. This will be even more problematic – if not impossible – under arrangements that do not involve an individual account to which deferrals are contributed and earnings credited.
- As a result, many employers will likely no longer offer middle-management and other non-executive employees programs designed to complement the employer’s tax-qualified retirement plans by allowing employees to save for retirement on their total compensation.
- Many employers also will likely redesign their RSU and other long-term incentive compensation programs to eliminate graded vesting and retirement vesting features and instead provide for cliff vesting and immediate payout to fit within the short-term deferral exception, putting more compensation at risk for the middle management and other non-executive employees covered by these arrangements.