January 23, 2007

Dear Senator:

The American Benefits Council (the "Council") is writing to express our opposition to two provisions contained in the Small Business and Work Opportunity Act of 2007 as reported out of the Finance Committee. These proposals go much farther than is necessary to address any perceived abuses and would have unintended consequences that would be very harmful to both employees and employers.

The Council's more than 250 members include primarily major U.S. employers that provide employee benefits to active and retired workers, and do business in most, if not all, states. The Council's membership also includes organizations that provide services to employers of all sizes regarding their employee benefit programs. Collectively, the Council's members either directly sponsor or provide services to retirement and health benefit plans covering more than 100 million Americans.

Specifically, the Council has strong concerns regarding the provisions in the Act that would limit an individual's annual deferrals of nonqualified deferred compensation under Code section 409A and expand the deduction limits in Code section 162(m). These proposals come at a time when employers and regulators are still grappling with and trying to implement the sweeping new requirements imposed by section 409A. Moreover, the provisions would apply retroactively.

The proposed limit on annual deferrals is a highly intrusive tax penalty on a company's fundamental business decision to pay employees through deferred rather than current compensation. The provision essentially takes away an important human resources and management tool that businesses both large and small utilize to retain and attract employee talent. When a business chooses to pay its employees through deferred rather than current compensation, it ties the employee to the business in a meaningful way. The employee is a general creditor. The deferred compensation cannot be funded, or escrowed or protected from creditors and the business takes no tax deduction until the employee is paid. The proposal would create an arbitrary limit on deferred compensation that applies not just to top corporate executives, but also to middle managers, sales people, and other employees of both public and private employers. If an individual's annual deferrals, including earnings, were to exceed the proposed limit, all of the individual's deferred compensation would be subject to

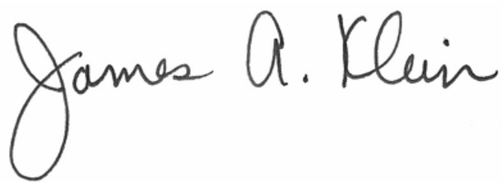
immediate taxation, a 20 percent additional tax and interest -- even though the individual had not received any payments and would not be protected if the employer became insolvent.

Concerns about the size of compensation packages paid by corporations to CEOs and other top executives should be addressed through corporate governance changes -- not through the tax code. In fact, the Joint Committee on Taxation in its report on Enron recommended that section 162(m) be *repealed* and, at a hearing held by the Finance Committee last fall, virtually all government and other witnesses testified to the negative effects caused by section 162(m). Instead, the legislation would dramatically expand section 162(m) and add a far-reaching new compensation limit to the tax code.

Attached are examples describing how the proposals would apply and some of the many negative – and we believe inappropriate – consequences.

We appreciate your taking our views into consideration.

Sincerely,



James A. Klein
President

Examples

Example 1. *Supplemental 401(k) earnings*. 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 or "mirror" 401(k) plan as additional deferrals that count against the "one-times pay" cap and could cause the employee to exceed the cap. Since earnings that are tied to a publicly traded investment are often very unpredictable, the employee would have to leave a large cushion below the "one-times pay cap" to take into account potential earnings. An employee who participates over his or her career could easily exceed the one-times pay cap solely with respect to earnings in the later years.

Example 2. *Defined benefit plans*. Companies may assist management employees in saving for retirement through supplemental pension programs. 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 one-times pay 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 retirement 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.

Example 3. *Private equity*. Many non-publicly traded companies cannot readily conform to the specific administrative rules provided under 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 and will be treated as NQDC. Under the legislation, private companies could not provide this type of equity grant to employees unless they were capped each year by a "one times pay" limit. Since "earnings" on the equity are also limited under the legislation, employees would have a tax penalty under 409A merely because the company was successful and the value of the equity increased beyond the one-times pay limit.

Example 4. *Bonuses and incentive plans*. 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 bonus being treated as NQDC. Some employers may need to wait longer for performance criteria to be ascertained, financials certified, etc., which means that the bonus or long-term incentive pay would be treated as NQDC and, therefore, subject to the one-times pay cap. In other instances, the employee may vest in increments over the performance period but is not paid until the end of the period after full vesting is attained, which also would result in the pay being treated as NQDC and subject to the one-times pay cap.

Example 5. *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 legislation limits the business from making any promise that exceeds one-times pay for employees.