Paul | Weiss

January 24, 2007

New Tax Bill Would Put a Dollar Limit on Nonqualified Deferred Compensation under Section 409A, Broaden Section 162(m)'s $1 Million Deduction Limit

On January 17, 2007, the Senate Finance Committee unanimously approved, by voice vote, a bill which would broaden tax code section 409A by imposing an annual dollar limit on the amount of nonqualified deferred compensation that can accrue in any year for any one person. In addition, for public companies, the $1 million deduction limit of tax code section 162(m) would be broadened to apply to post-employment payments to former officers. These compensation provisions are just a few of the changes included in the pending legislation, the "Small Business and Work Opportunity Act of 2007," the text of which only became available on January 22.

Broadened Reach of Section 409A

The new bill would broaden section 409A, the 2004 tax law which imposes complex rules on nonqualified deferred compensation plans. Failure to follow the section 409A rules can subject affected employees to accelerated income tax and a 20% penalty tax. The reach of section 409A is already great, because it applies not only to elective deferred compensation plans, but also to non-elective arrangements not traditionally thought of as "deferred compensation," including SERPs, discount stock options, some phantom stock and deal bonus plans, and some executive severance pay arrangements.

Last week's bill would impose an annual dollar limit on the amount of compensation which could be deferred in any one year on behalf of any one individual under a nonqualified deferred compensation plan. For any one person, the limit would be the lesser of $1 million or the individual's previous five-year average annual taxable compensation; earnings on prior deferrals would count against the limit. Failure to comply could trigger both ordinary income tax and the section 409A 20% penalty tax on all vested amounts previously deferred under the plan. These new limits on nonqualified deferred compensation would apply to plans of both private and public companies, and are not restricted to top officers.

The legislative report on the bill recognizes that some important questions will need to be answered by Treasury Regulations. For example, in the case of a nonqualified defined benefit plan (like a SERP) where the benefit is earned over perhaps many years of service, guidance will be needed on how to determine the amounts deferred in any one year and how to apply the annual dollar limitation to any one year.

All plans maintained by an employer (or by its affiliates) would be aggregated and treated as a single plan under these rules, so that $1 million per year would be the maximum possible annual deferral limit for any individual, under all nonqualified plans combined.

The proposal would be effective for amounts deferred in taxable years beginning after December 31, 2006, and to earnings on such deferrals. There would also be an opportunity provided to modify existing outstanding deferral elections in 2007 to the extent needed to comply with the proposal without violating section 409A, and to amend old plans to conform to the new requirements.

Broadened Application of Section 162(m)

Section 162(m) of the Internal Revenue Code limits to $1 million per person the amount of compensation deduction a public corporation can take in any one year for compensation paid to the corporation's chief executive officer and the four other most-highly compensated officers. Compensation over $1 million is deductible in cases where the excess represents performance-based compensation under a shareholder-approved plan, and the compensation goals and targets have been set in advance by a committee of outside directors, which must also certify that the performance goals have been met before any payments are made.

Under current law, deductions for compensation paid to such an officer are not limited by section 162(m) if the individual is not employed on the last day of the year for which the compensation is paid. So, deferred compensation paid during and after the year employment ends is, under current law, effectively outside the reach of section 162(m). In addition, the current section 162(m) rules do not apply to compensation paid to a person who ceases to be an officer during the year, even if that person is still employed at year end.

The proposed new legislation would extend the section 162(m) limitations to compensation paid to individuals who were officers subject to section 162(m) in an earlier year (looking only at "earlier years" starting after 2006) even if no longer employed when the compensation is paid. Moreover, the section 162(m) limitations will now apply to payments made to a covered officer's death beneficiary, but only with respect to compensation attributable to service as a covered officer. (The application of this rule could prove difficult where the payment is only partially attributable to prior service as a covered officer, for example, under a SERP.) As a result of these changes, SERPs, severance and other post-employment compensation will now generally be subject to section 162(m), ending a popular planning strategy for dealing with the section 162(m) limitations. Also, under the new bill, any person who was Chief Executive Officer at any time during the year would be covered by the section 162(m) rules. Another result of these changes is that the number of affected individuals could be greater than 5. The proposed new section 162(m) legislation would be effective for taxable years beginning after December 31, 2006.

What's Next?

Right now, the fate of last week's proposal is uncertain: These section 409A and 162(m) proposed changes are viewed as revenue raisers in a bill generally designed to provide tax relief to small businesses; and these small-business tax breaks could become a critical part of the legislative fight over a proposed increase to the minimum wage. Moreover, strong criticism of the proposed section 409A and 162(m) changes has already been voiced by important business groups, including the American Bankers Association, the Securities Industry and Financial Markets Association and the US Chamber of Commerce. Nevertheless, last week's action suggests that there may be important bipartisan support for restricting nonqualified deferred compensation for executives, including but not limited to top executives of public corporations.

* * *

This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. For more information on the foregoing, please call Rob Fleder (212-373-3107), Mike Segal (212-373-3364) or Larry Witdorchic (212-373-3237).