



## Impact of Senate's Proposal to Limit Deferrals of Compensation

Provided below are several examples showing how the Senate's proposal to limit deferrals of compensation would impact employees at all levels and not just the most senior executives at public companies. As proposed, the maximum amount an individual could defer in a year would be limited to the lesser of \$1 million or the 5-year average of the individual's taxable compensation (the "Proposed Dollar Limit"). This limit would be added to Section 409A of the Internal Revenue Code.

### Severance Arrangements

Manufacturer needs to reduce its headcount and decides to offer a number of employees a voluntary severance package providing for 2 months of severance for each year of service, plus continued medical coverage at employer cost for 1 year. Because Employee has 13 years of service and current compensation of \$65,000, the total severance package offered to him would equal \$140,833. Payments would start in December 2007 and would end in early 2010. The Employee's 5-year average of taxable compensation in this case is \$59,000.

Voluntary severance packages are exempt from Section 409A only if all severance payments are completed by the end of the second year following year of termination and if total payments do not exceed lesser of 2x compensation or 2x the limit under Section 401(a)(17). Manufacturer's severance arrangement does not meet the requirements for this exemption, since payments would exceed 2x the Employee's compensation and would not be completed by the end of the second year following the year of termination.

Effect of Proposed Dollar Limit: The Proposed Dollar Limit for the Employee would be \$59,000 since the employee's annualized income is less than \$1,000,000. It is not clear how to value the severance package, but presumably it would be, at a minimum, the present value of the stream of severance payments totaling \$140,833, which for these purposes is assumed to be \$125,000. Because this amount would exceed \$59,000 under the Proposed Dollar Limit, Employee would be subject to immediate taxation on the stream of severance payments, \$140,833 in 2007, and depending on the value assigned to such stream for section 409A purposes, would also be liable for an additional surtax of approximately \$25,000.<sup>1</sup> Note that, although unlikely, if the Employee did have any other deferred compensation arrangement with Manufacturer that was subject to section 409A, the post-2006 deferrals under the other arrangement (including earnings) would also count towards the Proposed Dollar Limit, and such arrangement would be subject to current taxation in the manner described above if the Proposed Dollar Limit were exceeded.

### Earnings

Architect has been working at local practice for 10 years starting in 2007 with annual total compensation of \$250,000. While employed, Architect has been deferring an average of \$60,000, reducing architect's taxable compensation during the service period to an average of \$175,000 (when including reductions for 401(k) and health coverage). Architect's deferrals total \$600,000 and with earnings are worth \$925,000 at the end of 2016. Architect realizes that the earnings on these deferrals may approach the Proposed Dollar Limit, so she decides not to defer during 2017, but her deferrals in that year, hypothetically

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<sup>1</sup> This example states that the entire severance package would be a deferral although the actual amount of the "deferral" subject to Section 409A would likely not equal the entire \$140,833 since at least some portion would be paid in 2007 and not deferred into a future year.

invested in a high-growth, high-risk stock fund, end up earning 22%, or \$203,500. Architect's total account balance at the end of 2017 equals \$1,128,500.

Effect of Proposed Limit: Architect's earnings of \$203,500 during 2017 would exceed her annualized compensation of \$175,000. Full account balance of \$1,128,500 would be immediately taxable to the Architect and the Architect would face an excise tax of \$225,700. Note also that if the Architect did have any other deferred compensation arrangement with her employer that was subject to section 409A, the post-2006 deferrals under the other deferred compensation arrangement (including earnings) would also count towards the Proposed Dollar Limit, and such arrangement would be subject to current taxation in the manner described above if the Proposed Dollar Limit were exceeded.

#### Athletes-Structured Payments

Big-time slugger signs a long-term deal with the Washington Nationals for services beginning in 2007. The total deal is for 7 years and worth \$69 million, with Slugger receiving a \$14,000,000 signing bonus, \$5,000,000 for each 2007 through 2009 season, and \$10,000,000 for each 2010 through 2013 season. The signing bonus is fully vested and will be paid out ratably over 7 years beginning in 2008.

Slugger's deferred signing bonus would be subject to Section 409A because it provides for vested payments to be made in future taxable years in excess of the Proposed Dollar Limit.

Effect of Proposed Dollar Limit: Deferral of \$14,000,000 signing bonus would exceed the applicable \$1,000,000 limit. Plus, total deferral of \$14,000,000 would exceed first year compensation of \$5,000,000 (although it would be difficult to determine what annualized compensation is for a new employee). Note also that if Slugger had any other arrangement with the Nationals that was subject to section 409A, the post-2006 deferrals under that arrangement (including earnings) would also count towards the Proposed Dollar Limit, and such arrangement would be subject to current taxation in the manner described above if the Proposed Dollar Limit were exceeded.

#### Equity Arrangements—Earnings Again

**Example #1:** Programmer joins silicon valley-based Start-Up for an annual base salary of \$150,000 (with only \$135,000 taxable after 401(k) and health coverage reductions) plus a deferred stock award of 100,000 shares that will vest ratably over 3 years with payment of all stock at the start of the fourth year (some would refer to this arrangement as providing "restricted stock units"). Start-Up is not publicly traded and the market for Start-Up's stock is illiquid. Start-Up's stock price at the grant date is only \$1 per share. Programmer's salary doesn't change during 3-year period but Start-Up's software is a hit, and Start-Up's stock price climbs to \$6 per share at the end of year 1, \$9 at the end of year 2, and \$10 at the end of the year 3.

Effect of Proposed Dollar Limit: The initial deferral of \$100,000 would not exceed first year salary (assuming that first year salary would be used for determining annualized compensation) or the \$1,000,000 limit. However, the growth in the stock price would result in \$500,000 in earnings in year 1. Thus, the first year earnings would result in the Programmer having to immediately include all of the vested portion of the award or \$200,000 worth of company stock in taxable income at the end of year 1, plus an excise tax equal to \$40,000. (Presumably only the vested deferral would be measured and taxed.) Note also the impact of the aggregation rule that would require post-2006 deferrals (including earnings) under any other deferral plan or arrangement that Programmer had with Start-Up and that was subject to section 409A to be taken into account for these purposes. If the Programmer exceeded the Proposed Dollar Limit, all such arrangements would be subject to current taxation as described above.

**Example #2:** Same facts as Example #1, except that value of Start-Up stock only increases from \$1 to \$2 by the end of the year 2. However, during year 3, Start-Up goes public and is trading at \$18 at the end of year 3. Total earnings during year 3 (\$1,600,000) would exceed the \$1,000,000 limit (in addition to the annualized compensation limit). Programmer would face an excise tax of \$360,000 based on entire \$1,800,000 at the end of year 3 (plus immediate tax, including interest and the 20% penalty tax, on all other post-2006 deferred compensation subject to Section 409A).

### Supplemental Pension Arrangements

Manufacturer offers company-wide pension plan designed to replace approximately 20% of an employee's income upon retirement. Due to IRS limits on tax-qualified plans, the company-wide pension plan can only replace approximately 5 to 10% of income upon retirement for Manufacturer's executives. Consequently, Manufacturer also offers a supplemental retirement plan for its executives (a "SERP"). The SERP provides the same benefit formula as the company-wide plan except that the benefit formula is not subject to the IRS-imposed limits on benefits. The SERP provides for payment upon termination of employment, but benefits are steeply discounted if an executive leaves and starts payment before reaching "Retirement Age" (either age 65 or age 55 with 15 years of service). Similar to the company-wide plan, upon reaching Retirement Age, the executive is entitled to receive an unreduced benefit. Assume for simplicity that all benefits under the company-wide plan and the SERP are payable only in the form of a life annuity.

Engineer has been with Manufacturer for 20 years and has annualized compensation, including incentive pay, of approximately \$300,000. Prior to reaching Retirement Age, Engineer's total accrued benefit under the SERP (after 20 years of service) has an actuarial value of \$500,000. However, upon reaching age 55, the Engineer becomes entitled to receive a full and unreduced benefit commencing immediately, and, as a result, the present value of Engineer's accrued benefit increases to \$825,000. The Engineer retires and begins receiving payment in the form of a life annuity.

Effect of Proposed Dollar Limit: The increase in the actuarial value of the Engineer's benefit upon reaching Retirement Age (age 55 with at least 15 years of service) would result in an increase in the Engineer's benefit of approximately \$325,000 in that year thus exceeding the Engineer's annualized compensation of \$300,000. Engineer would be subject to immediate taxation on the entire \$825,000—even though the Engineer cannot receive payment of that amount all at once—and Engineer would be subject to an excise tax of \$165,000. Note also the impact of the aggregation rule under the proposed legislation. Even if the increase in Engineer's SERP benefit were only \$275,000, Engineer would be subject to immediate tax, including interest and the 20% penalty tax, if Engineer happened to also have \$50,000 in deferrals in the year of retirement under a bonus deferral arrangement with Manufacturer that was subject to section 409A.

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